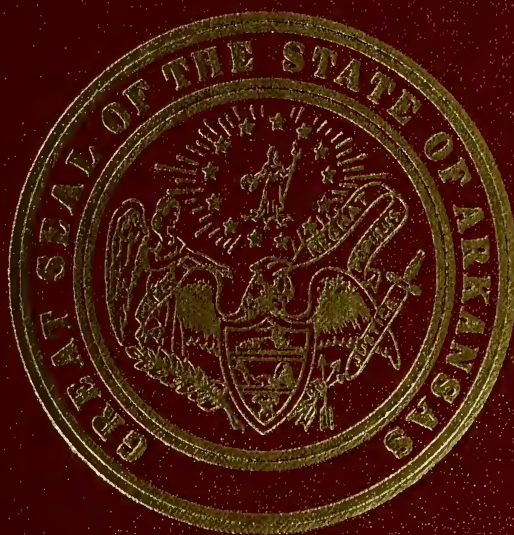


# ARKANSAS CODE OF 1987 ANNOTATED

OFFICIAL EDITION



COMMENTARIES  
VOLUME A (T. 1-4)



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# ARKANSAS CODE OF 1987 ANNOTATED



## COMMENTARIES

**1995 Replacement  
Volume A**

*Prepared by the Staff of the Arkansas Code Revision Commission*

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**THE MICHIE COMPANY**


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**1995**



ARKANSAS CODE  
OF 1987  
ANNOTATED



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## Arkansas Code Revision Commission Preface

In preparing the Arkansas Code of 1987, the Arkansas Code Revision Commission has tried to determine which parts of the Arkansas Code of 1987 are derived from uniform acts, model acts, and other acts prepared by various organizations and adopted by the Arkansas General Assembly for which official commentaries were prepared. When available, the official commentaries to the various uniform, model, and other acts have been collected and notes inserted by the commission to explain the additions, deletions, and changes made in the texts of the acts as adopted in Arkansas. These commentaries and additional notes by the commission are published for the convenience of practitioners in Arkansas.

Every effort has been made to assure the accuracy of the commission-added notes to the commentaries; however, the commission-added notes are not official commentaries and should not be relied upon to the same extent as the official commentaries.

When the Arkansas General Assembly enacted the Arkansas Criminal Code of 1975, it considered the official commentary by the Criminal Code Revision Commission along with the text of the then-proposed Criminal Code. Since adoption of the Criminal Code in 1975, Frank Newell, one of the original drafters of the Arkansas Criminal Code, has prepared and published commentaries to the Criminal Code explaining changes made to the Criminal Code by the Arkansas General Assembly since its adoption and court decisions interpreting the Criminal Code. The commentaries by Frank Newell, although not official, have been included and may be helpful to practitioners in Arkansas.





## **Publisher's Preface**

The two Commentaries volumes of the Arkansas Code of 1987 Annotated reprint commentaries to various uniform laws, model acts, etc., which are codified in the Code. Permission to reprint these commentaries was obtained by the Arkansas Code Revision Commission. The text of the commentaries was provided by the staff of the Arkansas Code Revision Commission; footnotes were also reviewed or added by the Commission.

Suggestions, comments, or questions about this or any other volume of the Code are welcome. You may call our toll-free number, 1-800-446-3410, fax us toll free at 1-800-643-1280, or write: Arkansas Code Editor, The Michie Company, P.O. Box 7587, Charlottesville, Virginia, 22906.

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## User's Guide

Many of the Arkansas Code's research aids, as well as its organization and other features, are described in the User's Guide, which appears near the beginning of Volume 1 of the Code.





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# TITLE 4

## BUSINESS AND COMMERCIAL LAW

### UNIFORM COMMERCIAL CODE (§ 4-1-101 ET SEQ.)

**A.C.R.C. Notes.** Unless otherwise noted, all commentary is derived from the original Uniform Commercial Code commentary. References to "the Code" in the commentary refer to the Uniform Commercial Code.

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### ARTICLE 1 (A.C.A. § 4-1-101 et seq.)

#### Comment to § 1-101 (A.C.A. § 4-1-101)

Each Article (Chapter) of the Code (except this Article (Chapter) and Article 10 (Chapter 10)) may also be cited by its own short title. See Sections 2-101 (A.C.A. § 4-2-101), 3-101 (A.C.A. § 4-3-101), 4-101

(A.C.A. § 4-4-101), 5-101 (A.C.A. § 4-5-101), 6-101 (A.C.A. § 4-6-101), 7-101 (A.C.A. § 4-7-101), 8-101 (A.C.A. § 4-8-101) and 9-101 (A.C.A. § 4-9-101).

#### Comment to § 1-102 (A.C.A. § 4-1-102)

*Prior Uniform Statutory Provision:* Section 74, Uniform Sales Act; Section 57, Uniform Warehouse Receipts Act; Section 52, Uniform Bills of Lading Act; Section 19, Uniform Stock Transfer Act.

*Changes:* Rephrased and new material added.

*Purposes of Changes:*

1. Subsections (1) (A.C.A. § 4-1-102(1)) and (2) (A.C.A. § 4-1-102(2)) are intended to make it clear that:

This Act is drawn to provide flexibility so that, since it is intended to be a semi-permanent piece of legislation, it will provide its own machinery for expansion of commercial practices. It is intended to make it possible for the law embodied in this Act to be developed by the courts in the light of unforeseen and new circumstances and practices. However, the proper construction of the Act requires that its interpretation and application be limited to its reason.

Courts have been careful to keep broad acts from being hampered in their effects by later acts of limited scope. *Pacific Wool*

*Growers v. Draper & Co.*, 158 Or. 1, 73 P.2d 1391 (1937), and compare Section 1-104 (A.C.A. § 4-1-104). They have recognized the policies embodied in an act as applicable in reason to subject-matter which was not expressly included in the language of the act, *Commercial Nat. Bank of New Orleans v. Canal-Louisiana Bank & Trust Co.*, 239 U.S. 520, 36 S.Ct. 194, 60 L.Ed. 417 (1916) (bona fide purchase policy of Uniform Warehouse Receipts Act extended to case not covered but of equivalent nature). They have done the same where reason and policy so required, even where the subject-matter had been intentionally excluded from the act in general. *Agar v. Orda*, 264 N.Y. 248, 190 N.E. 479 (1934) (Uniform Sales Act change in seller's remedies applied to contract for sale of choses in action even though the general coverage of that Act was intentionally limited to goods "other than things in action.") They have implemented a statutory policy with liberal and useful remedies not provided in the statutory text. They have disregarded a statutory limitation of remedy where the rea-

son of the limitation did not apply. *Fitterman v. J. N. Johnson & Co.*, 156 Minn. 201, 194 N.W. 399 (1923) (requirement of return of the goods as a condition to rescission for breach of warranty; also, partial rescission allowed). Nothing in this Act stands in the way of the continuance of such action by the courts.

The Act should be construed in accordance with its underlying purposes and policies. The text of each section should be read in the light of the purpose and policy of the rule or principle in question, as also of the Act as a whole, and the application of the language should be construed narrowly or broadly, as the case may be, in conformity with the purposes and policies involved.

2. Subsection (3) (A.C.A. § 4-1-102(3)) states affirmatively at the outset that freedom of contract is a principal of the Code: "the effect" of its provisions may be varied by "agreement." The meaning of the statute itself must be found in its text, including its definitions, and in appropriate extrinsic aids; it cannot be varied by agreement. But the Code seeks to avoid the type of interference with evolutionary growth found in *Manhattan Co. v. Morgan*, 242 N.Y. 38, 150 N.E. 594 (1926). Thus private parties cannot make an instrument negotiable within the meaning of Article 3 (Chapter 3) except as provided in Section 3-104 (A.C.A. § 4-3-104); nor can they change the meaning of such terms as "bona fide purchaser," "holder in due course," or "due negotiation," as used in this Act. But an agreement can change the legal consequences which would otherwise flow from the provisions of the Act. "Agreement" here includes the effect given to course of dealing, usage of trade and course of performance by Sections 1-201 (A.C.A. § 4-1-201), 1-205 (A.C.A. § 4-1-205) and 2-208 (A.C.A. § 4-2-208); the effect of an agreement on the rights of third parties is left to specific provisions of this Act and to supplementary principles applicable under the next section. The rights of third parties under Section 9-301

(A.C.A. § 4-9-301) when a security interest is unperfected, for example, cannot be destroyed by a clause in the security agreement.

This principle of freedom of contract is subject to specific exceptions found elsewhere in the Act and to the general exception stated here. The specific exceptions vary in explicitness: the statute of frauds found in Section 2-201 (A.C.A. § 4-2-201), for example, does not explicitly preclude oral waiver of the requirement of a writing, but a fair reading denies enforcement to such a waiver as part of the "contract" made unenforceable; Section 9-501(3) (A.C.A. § 4-9-501(3)), on the other hand, is quite explicit. Under the exception for "the obligations of good faith, diligence, reasonableness and care prescribed by this Act," provisions of the Act prescribing such obligations are not to be disclaimed. However, the section also recognizes the prevailing practice of having agreements set forth standards by which due diligence is measured and explicitly provides that, in the absence of a showing that the standards manifestly are unreasonable, the agreement controls. In this connection, Section 1-205 (A.C.A. § 4-1-205) incorporating into the agreement prior course of dealing and usages of trade is of particular importance.

3. Subsection (4) (A.C.A. § 4-1-102(4)) is intended to make it clear that, as a matter of drafting, words such as "unless otherwise agreed" have been used to avoid controversy as to whether the subject matter of a particular section does or does not fall within the exceptions to subsection (3) (A.C.A. § 4-1-102(3)), but absence of such words contains no negative implication since under subsection (3) (A.C.A. § 4-1-102(3)) the general and residual rule is that the effect of all provisions of the Act may be varied by agreement.

4. Subsection (5) (A.C.A. § 4-1-102(5)) is modeled on 1 U.S.C. Section 1 and New York General Construction Law Sections 22 and 35.



**Comment to § 1-103 (A.C.A. § 4-1-103)**

*Prior Uniform Statutory Provision:* Sections 2 and 73, Uniform Sales Act; Section 196, Uniform Negotiable Instruments Act; Section 56, Uniform Warehouse Receipts Act; Section 51, Uniform Bills of Lading Act; Section 18, Uniform Stock Transfer Act.

*Changes:* Rephrased, the reference to “estoppel” and “validating” being new.

*Purposes of Changes:*

1. While this section indicates the continued applicability to commercial contracts of all supplemental bodies of law except insofar as they are explicitly displaced by this Act, the principle has been stated in more detail and the phrasing enlarged to make it clear that the “validating”, as well as the “invalidating” causes referred to in the prior uniform statutory provisions, are included here. “Validating” as used here in conjunction with “invalidating” is not intended as a

narrow word confined to original validation, but extends to cover any factor which at any time or in any manner renders or helps to render valid any right or transaction.

2. The general law of capacity is continued by express mention to make clear that section 2 of the old Uniform Sales Act (omitted in this Act as stating no matter not contained in the general law) is also consolidated in the present section. Hence, where a statute limits the capacity of a non-complying corporation to sue, this is equally applicable to contracts of sale to which such corporation is a party.

3. The listing given in this section is merely illustrative; no listing could be exhaustive. Nor is the fact that in some sections particular circumstances have led to express reference to other fields of law intended at any time to suggest the negation of the general application of the principles of this section.

**Comment to § 1-104 (A.C.A. § 4-1-104)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

To express the policy that no Act which bears evidence of carefully considered permanent regulative intention should lightly be regarded as impliedly repealed by subsequent legislation. This Act, care-

fully integrated and intended as a uniform codification of permanent character covering an entire “field” of law, is to be regarded as particularly resistant to implied repeal. See *Pacific Wool Growers v. Draper & Co.*, 158 Or. 1, 73 P.2d 1391 (1937).

**1972 Official Comment to § 1-105 (A.C.A. § 4-1-105)\***

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-1-105(1)) states affirmatively the right of the parties to a multi-state transaction or a transaction involving foreign trade to choose their own law. That right is subject to the firm rules stated in the five sections listed in subsection (2) (A.C.A. § 4-1-105(2)), and is limited to jurisdictions to which the transaction bears a “reasonable relation.” In general, the test of “reasonable relation” is similar to that laid down by the Supreme Court in *Seeman v. Philadelphia Warehouse Co.*, 274 U.S. 403, 47 S.Ct. 626, 71 L.Ed. 1123 (1927). Ordinarily the law chosen must be that of a jurisdiction where a significant enough

portion of the making or performance of the contract is to occur or occurs. But an agreement as to choice of law may sometimes take effect as a shorthand expression of the intent of the parties as to matters governed by their agreement, even though the transaction has no significant contact with the jurisdiction chosen.

2. Where there is no agreement as to the governing law, the Act is applicable to any transaction having an “appropriate” relation to any state which enacts it. Of course the Act applies to any transaction which takes place in its entirety in a state which has enacted the Act. But the mere fact that suit is brought in a state does not make it appropriate to apply the substantive law of that state. Cases where a

relation to the enacting state is not "appropriate" include, for example, those where the parties have clearly contracted on the basis of some other law, as where the law of the place of contracting and the law of the place of contemplated performance are the same and are contrary to the law under the Code.

3. Where a transaction has significant contacts with a state which has enacted the Act and also with other jurisdictions, the question what relation is "appropriate" is left to judicial decision. In deciding that question, the court is not strictly bound by precedents established in other contexts. Thus a conflict-of-laws decision refusing to apply a purely local statute or rule of law to a particular multi-state transaction may not be valid precedent for refusal to apply the Code in an analogous situation. Application of the Code in such circumstances may be justified by its comprehensiveness, by the policy of uniformity, and by the fact that it is in large part a reformulation and restatement of the law merchant and of the understanding of a business community which transcends state and even national boundaries. Compare *Global Commerce Corp. v. Clark-Babbitt Industries, Inc.*, 239 F.2d 716, 719 (2d Cir. 1956). In particular, where a transaction is governed in large part by the Code, application of another law to some detail of performance because of an accident of geography may violate the commercial understanding of the parties.

4. The Act does not attempt to prescribe choice-of-law rules for states which do not enact it, but this section does not prevent application of the Act in a court of such a state. Common-law choice of law often rests on policies of giving effect to agreements and of uniformity of result regardless of where suit is brought. To the extent that such policies prevail, the relevant considerations are similar in such a court to those outlined above.

5. Subsection (2) (A.C.A. § 4-1-105(2)) spells out essential limitations on the parties' right to choose the applicable law. Especially in Article 9 (Chapter 9) parties taking a security interest or asked to extend credit which may be subject to a security interest must have sure ways to find out whether and where to file and where to look for possible existing filings.

6. Section 9-103 (A.C.A. § 4-9-103) should be consulted as to the rules for perfection of security interests and the effects of perfection and nonperfection.

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\*This section was amended by Acts 1973, No. 116, § 2, to incorporate the 1972 changes to this Uniform Commercial Code section. This section was amended by Acts 1991, No. 344, § 2, and No. 540, § 2, to reflect the enactment of Article 4A (A.C.A. § 4-4A-101 et seq.). This section was also amended by Acts 1993, No. 439, § 3, to reflect the enactment of Article 2A (A.C.A. § 4-2A-101 et seq.).

### Comment to Section 1-105 (A.C.A. § 4-1-105)\*

*Uniform Statutory Source:* Section 1-105 (§ 4-1-105), 1978 Official Text of the Act (§ 4-1-101 et seq.).

*Changes:* Subsection (2) (§ 4-1-105(2)) is amended to reference two sections of the Article on Leases (Article 2A) (§ 4-2A-101

et seq.), which is being promulgated at the same time as this amendment.

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\*The version of this section enacted by Arkansas differs from the uniform act.

### Comment to § 1-106 (A.C.A. § 4-1-106)

*Prior Uniform Statutory Provision:* Subsection (1) (A.C.A. § 4-1-106(1)) — none; Subsection (2) (A.C.A. § 4-1-106(2)) — Section 72, Uniform Sales Act.

*Changes:* Reworded.

*Purposes of Changes and New Matter:* Subsection (1) (A.C.A. § 4-1-106(1)) is intended to effect three things:

1. First, to negate the unduly narrow or technical interpretation of some remedial provisions of prior legislation by providing that the remedies in this Act are to be liberally administered to the end stated in the section. Second, to make it clear that compensatory damages are limited to compensation. They do not include consequential or special damages, or penal



damages; and the Act elsewhere makes it clear that damages must be minimized. Cf. Sections 1-203 (A.C.A. § 4-1-203), 2-706(1) (A.C.A. § 4-2-706(1)), and 2-712(2) (A.C.A. § 4-2-712(2)). The third purpose of subsection (1) (A.C.A. § 4-1-106(1)) is to reject any doctrine that damages must be calculable with mathematical accuracy. Compensatory damages are often at best approximate: they have to be proved with whatever definiteness and accuracy the facts permit, but no more. Cf. Section 2-204(3) (A.C.A. § 4-2-204(3)).

2. Under subsection (2) (A.C.A. § 4-1-106(2)) any right or obligation described in this Act is enforceable by court action, even though no remedy may be expressly provided, unless a particular provision specifies a different and limited effect. Whether specific performance or other equitable relief is available is determined not by this section but by specific provisions and by supplementary principles. Cf. Sections 1-103 (A.C.A. § 4-1-103), 2-716 (A.C.A. § 4-2-716).

### Comment to § 1-107 (A.C.A. § 4-1-107)

*Prior Uniform Statutory Provision:* Compare Section 1, Uniform Written Obligations Act; Sections 119(3), 120(2) and 122, Uniform Negotiable Instruments Law.

#### *Purposes:*

This section makes consideration unnecessary to the effective renunciation or waiver of rights or claims arising out of an alleged breach of a commercial contract where such renunciation is in writing and signed and delivered by the aggrieved party. Its provisions, however, must be read in conjunction with the section imposing an obligation of good faith. (Section 1-203 (A.C.A. § 4-1-203)). There may, of course, also be an oral renunciation or waiver sustained by consideration but subject to Statute of Frauds provisions and to the section of Article 2 (Chapter 2)

3. "Consequential" or "special" damages and "penal" damages are not defined in terms in the Code, but are used in the sense given them by the leading cases on the subject.

*Cross References:* Sections 1-103 (A.C.A. § 4-1-103), 1-203 (A.C.A. § 4-1-203), 2-204(3) (A.C.A. § 4-2-204(3)), 2-701 (A.C.A. § 4-2-701), 2-706(1) (A.C.A. § 4-2-706(1)), 2-712(2) (A.C.A. § 4-2-712(2)) and 2-716 (A.C.A. § 4-2-716).

#### *Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

on Sales dealing with the modification of signed writings (Section 2-209 (A.C.A. § 4-2-209)). As is made express in the latter section this Act fully recognizes the effectiveness of waiver and estoppel.

#### *Cross References:*

Sections 1-203 (A.C.A. § 4-1-203), 2-201 (A.C.A. § 4-2-201) and 2-209 (A.C.A. § 4-2-209). And see Section 2-719 (A.C.A. § 4-2-719).

#### *Definitional Cross References:*

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

### Comment to § 1-201 (A.C.A. § 4-1-201)\*

*Prior Uniform Statutory Provision, Changes and New Matter:*

1. "Action". See similar definitions in Section 191, Uniform Negotiable Instruments Law; Section 76, Uniform Sales Act; Section 58, Uniform Warehouse Re-

ceipts Act; Section 53, Uniform Bills of Lading Act. The definition has been rephrased and enlarged.

2. "Aggrieved party". New.

3. "Agreement". New. As used in this Act the word is intended to include full



recognition of usage of trade, course of dealing, course of performance and the surrounding circumstances as effective parts thereof, and of any agreement permitted under the provisions of this Act to displace a stated rule of law.

4. "Bank". See Section 191, Uniform Negotiable Instruments Law.

5. "Bearer". From Section 191, Uniform Negotiable Instruments Law. The prior definition has been broadened.

6. "Bill of Lading". See similar definitions in Section 1, Uniform Bills of Lading Act. The definition has been enlarged to include freight forwarders' bills and bills issued by contract carriers as well as those issued by common carriers. The definition of airbill is new.

7. "Branch". New.

8. "Burden of establishing a fact". New.

9. 1972 Comment [See, also, 1972 comment to amended subsec. 9 below] "Buyer in ordinary course of business". From Section 1, Uniform Trusts Receipts Act. The definition has been expanded to make clear the type of person protected. Its major significance lies in Section 2-403 (A.C.A. § 4-2-403) and in the Article (Chapter) on Secured Transactions (Article 9 (Chapter 9)).

9. [See, also, comment to subsec. 9 above] "Buyer in ordinary course of business". From Section 1, Uniform Trust Receipts Act. The definition has been expanded to make clear the type of person protected. Its major significance lies in Section 2-403 (A.C.A. § 4-2-403) and in the Article (Chapter) on Secured Transactions (Article 9 (Chapter 9)).

The reference to minerals and the like makes clear that a buyer in ordinary course buying minerals under the circumstances described takes free of a prior mortgage created by the sellers. See Comment to Section 9-103 (A.C.A. § 4-9-103).

A pawnbroker cannot be a buyer in ordinary course of business because the person from whom he buys goods (or acquires ownership after foreclosing an initial pledge) is typically an ordinary user and not a person engaged in selling goods of that kind.

10. "Conspicuous". New. This is intended to indicate some of the methods of making a term attention-calling. But the test is whether attention can reasonably be expected to be called to it.

11. "Contract". New. But see Sections 3 and 71, Uniform Sales Act.

12. "Creditor". New.

13. "Defendant". From Section 76, Uniform Sales Act. Rephrased.

14. "Delivery". Section 76, Uniform Sales Act; Section 191, Uniform Negotiable Instruments Law; Section 58, Uniform Warehouse Receipts Act; and Section 53, Uniform Bills of Lading Act.

15. "Document of title". From Section 76, Uniform Sales Act, but rephrased to eliminate certain ambiguities. Thus, by making it explicit that the obligation or designation of a third party as "bailee" is essential to a document of title, this definition clearly rejects any such result as obtained in *Hixson v. Ward*, 254 Ill. App. 505 (1929), which treated a conditional sales contract as a document of title. Also the definition is left open so that new types of documents may be included. It is unforeseeable what documents may one day serve the essential purpose now filled by warehouse receipts and bills of lading. Truck transport has already opened up problems which do not fit the patterns of practice resting upon the assumption that a draft can move through banking channels faster than the goods themselves can reach their destination. There lie ahead air transport and such probabilities as teletype transmission of what may some day be regarded commercially as "Documents of Title". The definition is stated in terms of the function of the documents with the intention that any document which gains commercial recognition as accomplishing the desired result shall be included within its scope. Fungible goods are adequately identified within the language of the definition by identification of the mass of which they are a part.

Dock warrants were within the Sales Act definition of document of title apparently for the purpose of recognizing a valid tender by means of such paper. In current commercial practice a dock warrant or receipt is a kind of interim certificate issued by steamship companies upon delivery of the goods at the dock, entitling a designated person to have issued to him at the company's office a bill of lading. The receipt itself is invariably nonnegotiable in form although it may indicate that a negotiable bill is to be forthcoming. Such a document is not within the general compass of the definition, although trade us-

age may in some cases entitle such paper to be treated as a document of title. If the dock receipt actually represents a storage obligation undertaken by the shipping company, then it is a warehouse receipt within this Section regardless of the name given to the instrument.

The goods must be "described", but the description may be by marks or labels and may be qualified in such a way as to disclaim personal knowledge of the issuer regarding contents or condition. However, baggage and parcel checks and similar "tokens" of storage which identify stored goods only as those received in exchange for the token are not covered by this Article.

The definition is broad enough to include an airway bill.

16. "Fault". From Section 76, Uniform Sales Act.

17. "Fungible". See Sections 5, 6 and 76, Uniform Sales Act; Section 58, Uniform Warehouse Receipts Act. Fungibility of goods "by agreement" has been added for clarity and accuracy.

18. "Genuine". New.

19. "Good faith". See Section 76(2), Uniform Sales Act; Section 58(2), Uniform Warehouse Receipts Act; Section 53(2), Uniform Bills of Lading Act; Section 22(2), Uniform Stock Transfer Act. "Good faith" whenever it is used in the Code, means at least what is here stated. In certain Articles (Chapters), by specific provisions, additional requirements are made applicable. See, e.g., Secs. 2-103(1)(b) (A.C.A. § 4-2-103(1)(b)), 7-404 (A.C.A. § 4-7-404). To illustrate, in the Article (Chapter) on Sales, Section 2-103 (A.C.A. § 4-2-103), good faith is expressly defined as including in the case of a merchant observance of reasonable commercial standards of fair dealing in the trade, so that throughout that Article (Chapter) wherever a merchant appears in the case an inquiry into his observance of such standards is necessary to determine his good faith.

20. "Holder". See similar definitions in Section 191, Uniform Negotiable Instruments Law; Section 58, Uniform Warehouse Receipts Act; Section 53, Uniform Bills of Lading Act.

21. "Honor". New.

22. "Insolvency proceedings". New.

23. "Insolvent". Section 76(3), Uniform Sales Act. The three tests of insolvency — "ceased to pay his debts in the ordinary

course of business," "cannot pay his debts as they become due," and "insolvent within the meaning of the federal bankruptcy law" — are expressly set up as alternative tests and must be approached from a commercial standpoint.

24. "Money". Section 6(5), Uniform Negotiable Instruments Law. The test adopted is that of sanction of government, whether by authorization before issue or adoption afterward, which recognizes the circulating medium as a part of the official currency of that government. The narrow view that money is limited to legal tender is rejected.

25. "Notice". New. Compare N.I.L. Sec. 56. Under the definition a person has notice when he has received a notification of the fact in question. But by the last sentence the act leaves open the time and circumstances under which notice or notification may cease to be effective. Therefore such cases as *Graham v. White-Phillips Co.*, 296 U.S. 27, 56 S.Ct. 21, 80 L.Ed. 20 (1935), are not overruled.

26. "Notifies". New. This is the word used when the essential fact is the proper dispatch of the notice, not its receipt. Compare "Send". When the essential fact is the other party's receipt of the notice, that is stated. The second sentence states when a notification is received.

27. New. This makes clear that reason to know, knowledge, or a notification, although "received" for instance by a clerk in Department A of an organization, is effective for a transaction conducted in Department B only from the time when it was or should have been communicated to the individual conducting that transaction.

28. "Organization". This is the definition of every type of entity or association, excluding an individual, acting as such. Definitions of "person" were included in Section 191, Uniform Negotiable Instruments Law; Section 76, Uniform Sales Act; Section 58, Uniform Warehouse Receipts Act; Section 53, Uniform Bills of Lading Act; Section 22, Uniform Stock Transfer Act; Section 1, Uniform Trust Receipts Act. The definition of "organization" given here includes a number of entities or associations not specifically mentioned in prior definition of "person", namely, government, governmental subdivision or agency, business trust, trust and estate.



29. "Party". New. Mention of a party includes, of course, a person acting through an agent. However, where an agent comes into opposition or contrast to his principal, particular account is taken of that situation.

30. "Person". See Comment to definition of "Organization". The reference to Section 1-102 (A.C.A. § 4-1-102) is to subsection (5) (A.C.A. § 4-1-102(5)) of that section.

31. "Presumption". New.

32. "Purchase". Section 58, Uniform Warehouse Receipts Act; Section 76, Uniform Sales Act; Section 53, Uniform Bills of Lading Act; Section 22, Uniform Stock Transfer Act; Section 1, Uniform Trust Receipts Act. Rephrased.

33. "Purchaser". Section 58, Uniform Warehouse Receipts Act; Section 76, Uniform Sales Act; Section 53, Uniform Bills of Lading Act; Section 22, Uniform Stock Transfer Act; Section 1, Uniform Trust Receipts Act. Rephrased.

34. "Remedy". New. The purpose is to make it clear that both remedy and rights (as defined) include those remedial rights of "self help" which are among the most important bodies of rights under this Act, remedial rights being those to which an aggrieved party can resort on his own motion.

35. "Representative". New.

36. "Rights". New. See Comment to "Remedy".

37. [See, also, 1972 comment to amended subsection 37 below] "Security Interest". See Section 1, Uniform Trust Receipts Act. The present definition is elaborated, in view especially of the complete coverage of the subject in Article 9 (Chapter 9). Notice that in view of the Article (Chapter) the term includes the interest of certain outright buyers of certain kinds of property. The last two sentences give guidance on the question whether reservation of title under a particular lease of personal property is or is not a security interest.

37. 1972 Comment [See, also, comment to subsec. 37 above] "Security Interest". See Section 1, Uniform Trust Receipts Act. The present definition is elaborated, in view especially of the complete coverage of the subject in Article 9 (Chapter 9). Notice that in view of the Article (Chapter) the term includes the interest of certain outright buyers of certain kinds of property.

The last two sentences give guidance on the question whether reservation of title under a particular lease of personal property is or is not a security interest.

38. "Send". New. Compare "notifies".

39. "Signed". New. The inclusion of authentication in the definition of "signed" is to make clear that as that term is used in this Act a complete signature is not necessary. Authentication may be printed, stamped or written; it may be by initials or by thumbprint. It may be on any part of the document and in appropriate cases may be found in a billhead or letterhead. No catalog of possible authentications can be complete and the court must use common sense and commercial experience in passing upon these matters. The question always is whether the symbol was executed or adopted by the party with present intention to authenticate the writing.

40. "Surety". New.

41. "Telegram". New.

42. "Term". New.

43. Under the former version of § 1-201(43) (A.C.A. § 4-1-201(43)), it was not clear whether a reference to an "unauthorized signature" in Articles 3 and 4 (A.C.A. § 4-3-101 et seq. and § 4-4-101 et seq.) applied to indorsements. The words "or indorsement" are deleted so that references to "unauthorized signature" in § 3-406 (A.C.A. § 4-3-406) and elsewhere will unambiguously refer to any signature.

44. "Value". See Sections 25, 26, 27, 191, Uniform Negotiable Instruments Law; Section 76, Uniform Sales Act; Section 53, Uniform Bills of Lading Act; Section 58, Uniform Warehouse Receipts Act; Section 22(1), Uniform Stock Transfer Act; Section 1, Uniform Trust Receipts Act. All the Uniform Acts in the commercial law field (except the Uniform Conditional Sales Act) have carried definitions of "value". All those definitions provided that value was any consideration sufficient to support a simple contract, including the taking of property in satisfaction of or as security for a pre-existing claim. Subsections (a) (A.C.A. § 4-1-201(44)(a)), (b) (A.C.A. § 4-1-201(44)(b)) and (d) (A.C.A. § 4-1-201(44)(d)) in substance continue the definitions of "value" in the earlier acts. Subsection (c) (A.C.A. § 4-1-201(44)(c)) makes explicit that "value" is also given in a third situation: where a buyer by taking delivery under a preexist-

ing contract converts a contingent into a fixed obligation.

This definition is not applicable to Articles 3 and 4 (Chapters 3 and 4), but the express inclusion of immediately available credit as value follows the separate definitions in those Articles (Chapters). See Sections 4-208 (A.C.A. § 4-4-208), 4-209 (A.C.A. § 4-4-209), 3-303 (A.C.A. § 4-3-303). A bank or other financing agency which in good faith makes advances against property held as collateral becomes a bona fide purchaser of that property even though provision may be made for charge-back in case of trouble. Checking credit is "immediately available" within the meaning of this section if the bank would be subject to an action for slander of credit in case checks drawn against the credit were dishonored, and when a charge-back is not discretionary with the bank, but may only be made when difficulties in collection arise in connection with the specific transaction involved.

45. "Warehouse receipt". See Section 76(1), Uniform Sales Act; Section 1, Uniform Warehouse Receipts Act. Receipts issued by a field warehouse are included, provided the warehouseman and the depositor of the goods are different persons.

46. "Written" or "writing". This is a broadening of the definition contained in Section 191 of the Uniform Negotiable Instruments Law.

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\*This section was amended by Acts 1967, No. 303, § 2 (§ 1-201), to incorporate the 1962 changes to this Uniform Commercial Code section by adding the last two sentences of subsection (27). It was amended again by Acts 1973, No. 116, § 2, to incorporate the 1972 changes to this Uniform Commercial Code section and was amended by Acts 1985, No. 514, § 1, to incorporate the 1977 changes to this Uniform Commercial Code section. This section was amended by Acts 1991, No. 572, §§ 1-3.

### Official Comment to Section 1-201(37) (A.C.A. § 4-1-201(37))\*

*Uniform Statutory Source:* Section 1-201(37) (§ 4-1-201(37)), 1978 Official Text of the Act (§ 4-1-101 et seq.).

*Changes:* Substantially revised.

*Purposes:*

This amendment to Section 1-201(37) (§ 4-1-201(37)) is being promulgated at the same time that the Article on Leases (Article 2A) (§ 4-2A-101 et seq.) is being promulgated as an amendment to this Act (§ 4-1-101 et seq.).

One of the reasons it was decided to codify the law with respect to leases was to resolve an issue that has created considerable confusion in the courts: what is a lease? The confusion exists, in part, due to the last two sentences of the definition of security interest in the 1978 Official Text of the Act (§ 4-1-101 et seq.). Section 1-201(37) (§ 4-1-201(37)). The confusion is compounded by the rather considerable change in the federal, state and local tax laws and accounting rules as they relate to leases of goods. The answer is important because the definition of lease determines not only the rights and remedies of the parties to the lease but also those of third parties. If a transaction creates a

lease and not a security interest, the lessee's interest in the goods is limited to its leasehold estate; the residual interest in the goods belongs to the lessor. This has significant implications to the lessee's creditors. "On common law theory, the lessor, since he has not parted with title, is entitled to full protection against the lessee's creditors and trustee in bankruptcy..." 1 G. Gilmore, *Security Interests in Personal Property* § 3.6, at 76 (1965).

Under pre-Act chattel security law there was generally no requirement that the lessor file the lease, a financing statement, or the like, to enforce the lease agreement against the lessee or any third party; the Article on Secured Transactions (Article 9) (§ 4-9-101 et seq.) did not change the common law in that respect. Coogan, *Leasing and the Uniform Commercial Code*, in *Equipment Leasing — Leveraged Leasing* 681, 700 n.25, 729 n.80 (2d ed. 1980). The Article on Leases (Article 2A) (§ 4-2A-101 et seq.) has not changed the law in that respect, except for leases of fixtures. Section 2A-309 (§ 4-2A-309). An examination of the common law will not provide an adequate answer to the question of what is a lease. The defi-



nition of security interest in Section 1-201(37) (§ 4-1-201(37)) of the 1978 Official Text of the Act (§ 4-1-101 et seq.) provides that the Article on Secured Transactions (Article 9) (§ 4-9-101 et seq.) governs security interests disguised as leases, i.e., leases intended as security; however, the definition is vague and outmoded.

Lease is defined in Article 2A (§ 4-2A-101 et seq.) as a transfer of the right to possession and use of goods for a term, in return for consideration. Section 2A-103(1)(j) (§ 4-2A-103(1)(j)). The definition continues by stating that the retention or creation of a security interest is not a lease. Thus, the task of sharpening the line between true leases and security interests disguised as leases continues to be a function of this section.

The first paragraph of this definition is a revised version of the first five sentences of the 1978 Official Text of Section 1-201(37) (§ 4-1-201(37)). The changes are modest in that they make a style change in the fourth sentence and delete the reference to lease in the fifth sentence. The balance of this definition is new, although it preserves elements of the last two sentences of the prior definition. The focus of the changes was to draw a sharper line between leases and security interests disguised as leases to create greater certainty in commercial transactions.

Prior to this amendment, Section 1-201(37) (§ 4-1-201(37)) provided that whether a lease was intended as security (i.e., a security interest disguised as a lease) was to be determined from the facts of each case; however, (a) the inclusion of an option to purchase did not itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee would become, or had the option to become, the owner of the property for no additional consideration, or for a nominal consideration, did make the lease one intended for security.

Reference to the intent of the parties to create a lease or security interest has led to unfortunate results. In discovering intent, courts have relied upon factors that were thought to be more consistent with sales or loans than leases. Most of these criteria, however, are as applicable to true leases as to security interests. Examples

include the typical net lease provisions, a purported lessor's lack of storage facilities or its character as a financing party rather than a dealer in goods. Accordingly, amended Section 1-201(37) (§ 4-1-201(37)) deletes all reference to the parties' intent.

The second paragraph of the new definition is taken from Section 1(2) of the Uniform Conditional Sales Act (act withdrawn 1943), modified to reflect current leasing practice. Thus, reference to the case law prior to this Act (§ 4-1-101 et seq.) will provide a useful source of precedent. Gilmore, *Security Law, Formalism and Article 9*, 47 Neb. L. Rev. 659, 671 (1968). Whether a transaction creates a lease or a security interest continues to be determined by the facts of each case. The second paragraph further provides that a transaction creates a security interest if the lessee has an obligation to continue paying consideration for the term of the lease, if the obligation is not terminable by the lessee (thus correcting early statutory gloss, e.g. *In re Royer's Bakery, Inc.*, 1 U.C.C. Rep. Serv. (Callaghan) 342 (Bankr. E.D. Pa. 1963)) and if one of four additional tests is met. The first of these four tests, subparagraph (a), is that the original lease term is equal to or greater than the remaining economic life of the goods. The second of these tests, subparagraph (b), is that the lessee is either bound to renew the lease for the remaining economic life of the goods or to become the owner of the goods. *In re Gehrke Enters.*, 1 Bankr. 647, 651-52 (Bankr. W.D. Wis. 1979). The third of these tests, subparagraph (c), is whether the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration, which is defined later in this section. *In re Celeryvale Transp.*, 44 Bankr. 1007, 1014-15 (Bankr. E.D. Tenn. 1984). The fourth of these tests, subparagraph (d), is whether the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration. All of these tests focus on economics, not the intent of the parties. *In re Berge*, 32 Bankr. 370, 371-73 (Bankr. W.D. Wis. 1983).

The focus on economics is reinforced by the next paragraph, which is new. It states that a transaction does not create a

security interest merely because the transaction has certain characteristics listed therein. Subparagraph (a) has no statutory derivative; it states that a pay-out lease does not per se create a security interest. *Rushton v. Shea*, 419 F. Supp. 1349, 1365 (D. Del. 1976). Subparagraph (b) provides the same regarding the provisions of the typical net lease. *Compare All-States Leasing Co. v. Ochs*, 42 Or. App. 319, 600 P.2d 899 (Ct. App. 1979) with *In re Tillery*, 571 F.2d 1361 (5th Cir. 1978). Subparagraph (c) restates and expands the provisions of former Section 1-201(37) (§ 4-1-201(37)) to make clear that the option can be to buy or renew. Subparagraphs (d) and (e) treat fixed price options and provide that fair market value must be determined at the time the transaction is entered into. *Compare Arnold Mach. Co. v. Balls*, 624 P.2d 678 (Utah 1981) with *Aoki v. Shepherd Mach. Co.*, 665 F.2d 941 (9th Cir. 1982).

The relationship of the second paragraph of this subsection to the third paragraph of this subsection deserves to be explored. The fixed price purchase option provides a useful example. A fixed price purchase option in a lease does not of itself create a security interest. This is particularly true if the fixed price is equal

to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed. A security interest is created only if the option price is nominal and the conditions stated in the introduction to the second paragraph of this subsection are met. There is a set of purchase options whose fixed price is less than fair market value but greater than nominal that must be determined on the facts of each case to ascertain whether the transaction in which the option is included creates a lease or a security interest.

It was possible to provide for various other permutations and combinations with respect to options to purchase and renew. For example this section could have stated a rule to govern the facts of *In re Marhoefer Packing Co.*, 674 F.2d 1139 (7th Cir. 1982). This was not done because it would unnecessarily complicate the definition. Further development of this rule is left to the courts.

The fourth paragraph provides definitions and rules of construction.

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\*The version of this section enacted by Arkansas differs from the uniform act.

### Comment to § 1-202 (A.C.A. § 4-1-202)

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. This section is designed to supply judicial recognition for documents which have traditionally been relied upon as trustworthy by commercial men.

2. This section is concerned only with documents which have been given a preferred status by the parties themselves who have required their procurement in the agreement and for this reason the applicability of the section is limited to actions arising out of the contract which authorized or required the document. The documents listed are intended to be illustrative and not all inclusive.

3. The provisions of this section go no further than establishing the documents in question as prima facie evidence and leave to the court the ultimate determination of the facts where the accuracy or authenticity of the documents is questioned. In this connection the section calls for a commercially reasonable interpretation.

*Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Genuine". Section 1-201 (A.C.A. § 4-1-201).



**Comment to § 1-203 (A.C.A. § 4-1-203)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

This section sets forth a basic principle running throughout this Act. The principle involved is that in commercial transactions good faith is required in the performance and enforcement of all agreements or duties. Particular applications of this general principle appear in specific provisions of the Act such as the option to accelerate at will (Section 1-208 (A.C.A. § 4-1-208)), the right to cure a defective delivery of goods (Section 2-508 (A.C.A. § 4-2-508)), the duty of a merchant buyer who has rejected goods to effect salvage operations (Section 2-603 (A.C.A. § 4-2-603)), substituted performance (Section 2-614 (A.C.A. § 4-2-614)), and failure of presupposed conditions (Section 2-615 (A.C.A. § 4-2-615)). The concept, however, is broader than any of these illustrations and applies generally, as stated in this section, to the performance or enforcement of every contract or duty within this Act. It is further imple-

mented by Section 1-205 (A.C.A. § 4-1-205) on course of dealing and usage of trade.

It is to be noted that under the Sales Article (Chapter) definition of good faith (Section 2-103 (A.C.A. § 4-2-103)), contracts made by a merchant have incorporated in them the explicit standard not only of honesty in fact (Section 1-201 (A.C.A. § 4-1-201)), but also of observance by the merchant of reasonable commercial standards of fair dealing in the trade.

*Cross References:*

Section 1-201 (A.C.A. § 4-1-201); 1-205 (A.C.A. § 4-1-205); 1-208 (A.C.A. § 4-1-208); 2-103 (A.C.A. § 4-2-103); 2-508 (A.C.A. § 4-2-508); 2-603 (A.C.A. § 4-2-603); 2-614 (A.C.A. § 4-2-614); 2-615 (A.C.A. § 4-2-615).

*Definitional Cross References:*

“Contract”. Section 1-201 (A.C.A. § 4-1-201).

“Good faith”. Section 1-201 (A.C.A. § 4-1-201); 2-103 (A.C.A. § 4-2-103).

**Comment to § 1-204 (A.C.A. § 4-1-204)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-1-204(1)) recognizes that nothing is stronger evidence of a reasonable time than the fixing of such time by a fair agreement between the parties. However, provision is made for disregarding a clause which whether by inadvertence or overreaching fixes a time so unreasonable that it amounts to eliminating all remedy under the contract. The parties are not required to fix the most reasonable time but may fix any time which is not obviously unfair as judged by the time of contracting.

2. Under the section, the agreement which fixes the time need not be part of the main agreement, but may occur separately. Notice also that under the definition of “agreement” (Section 1-201 (A.C.A. § 4-1-201)) the circumstances of the transaction, including course of dealing or usages of trade or course of performance may be material. On the question what is a reasonable time these matters will often be important.

*Definitional Cross Reference:*

“Agreement”. Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 1-205 (A.C.A. § 4-1-205)\***

*Prior Uniform Statutory Provision:* No such general provision but see Sections 9(1), 15(5), 18(2), and 71, Uniform Sales Act.

*Purposes:* This section makes it clear that:

1. This Act rejects both the “lay-dictionary” and the “conveyancer’s” reading of a

commercial agreement. Instead the meaning of the agreement of the parties is to be determined by the language used by them and by their action, read and interpreted in the light of commercial practices and other surrounding circumstances. The measure and background for interpretation are set by the commercial context,

which may explain and supplement even the language of a formal or final writing.

2. Course of dealing under subsection (1) (A.C.A. § 4-1-205(1)) is restricted, literally, to a sequence of conduct between the parties previous to the agreement. However, the provisions of the Act on course of performance make it clear that a sequence of conduct after or under the agreement may have equivalent meaning. (Section 2-208 (A.C.A. § 4-2-208).)

3. "Course of dealing" may enter the agreement either by explicit provisions of the agreement or by tacit recognition.

4. This Act deals with "usage of trade" as a factor in reaching the commercial meaning of the agreement which the parties have made. The language used is to be interpreted as meaning what it may fairly be expected to mean to parties involved in the particular commercial transaction in a given locality or in a given vocation or trade. By adopting in this context the term "usage of trade" this Act expresses its intent to reject those cases which see evidence of "custom" as representing the effort to displace or negate "established rules of law". A distinction is to be drawn between mandatory rules of law such as the Statute of Frauds provisions of Article 2 (Chapter 2) on Sales whose very office is to control and restrict the actions of the parties, and which cannot be abrogated by agreement, or by a usage of trade, and those rules of law (such as those in Part 3 of Article 2 (Chapter 2) on Sales) which fill in points which the parties have not considered and in fact agreed upon. The latter rules hold "unless otherwise agreed" but yield to the contrary agreement of the parties. Part of the agreement of the parties to which such rules yield is to be sought for in the usages of trade which furnish the background and give particular meaning to the language used, and are the framework of common understanding controlling any general rules of law which hold only when there is no such understanding.

5. A usage of trade under subsection (2) (A.C.A. § 4-1-205(2)) must have the "regularity of observance" specified. The ancient English tests for "custom" are abandoned in this connection. Therefore, it is not required that a usage of trade be "ancient or immemorial", "universal" or the like. Under the requirement of subsection (2) (A.C.A. § 4-1-205(2)) full recogni-

tion is thus available for new usages and for usages currently observed by the great majority of decent dealers, even though dissidents ready to cut corners do not agree. There is room also for proper recognition of usage agreed upon by merchants in trade codes.

6. The policy of this Act controlling explicit unconscionable contracts and clauses (Sections 1-203 (A.C.A. § 4-1-203), 2-302 (A.C.A. § 4-2-302)) applies to implicit clauses which rest on usage of trade and carries forward the policy underlying the ancient requirement that a custom or usage must be "reasonable". However, the emphasis is shifted. The very fact of commercial acceptance makes out a prima facie case that the usage is reasonable, and the burden is no longer on the usage to establish itself as being reasonable. But the anciently established policing of usage by the courts is continued to the extent necessary to cope with the situation arising if an unconscionable or dishonest practice should become standard.

7. Subsection (3) (A.C.A. § 4-1-205(3)), giving the prescribed effect to usages of which the parties "are or should be aware", reinforces the provision of subsection (2) (A.C.A. § 4-1-205(2)) requiring not universality but only the described "regularity of observance" of the practice or method. This subsection also reinforces the point of subsection (2) (A.C.A. § 4-1-205(2)) that such usages may be either general to trade or particular to a special branch of trade.

8. Although the terms in which this Act defines "agreement" include the elements of course of dealing and usage of trade, the fact that express reference is made in some sections to those elements is not to be construed as carrying a contrary intent or implication elsewhere. Compare Section 1-102(4) (A.C.A. § 4-1-102(4)).

9. In cases of a well established line of usage varying from the general rules of this Act where the precise amount of the variation has not been worked out into a single standard, the party relying on the usage is entitled, in any event, to the minimum variation demonstrated. The whole is not to be disregarded because no particular line of detail has been established. In case a dominant pattern has been fairly evidenced, the party relying on the usage is entitled under this section to



go to the trier of fact on the question of whether such dominant pattern has been incorporated into the agreement.

10. Subsection (6) (A.C.A. § 4-1-205(6)) is intended to insure that this Act's liberal recognition of the needs of commerce in regard to usage of trade shall not be made into an instrument of abuse.

*Cross References:*

Point 1: Sections 1-203 (A.C.A. § 4-1-203), 2-104 (A.C.A. § 4-2-104) and 2-202 (A.C.A. § 4-2-202).

Point 2: Section 2-208 (A.C.A. § 4-2-208).

Point 4: Section 2-201 (A.C.A. § 4-2-201) and Part 3 of Article 2 (Chapter 2).

Point 6: Sections 1-203 (A.C.A. § 4-1-203) and 2-302 (A.C.A. § 4-2-302).

Point 8: Sections 1-102 (A.C.A. § 4-1-102) and 1-201 (A.C.A. § 4-1-201).

Point 9: Section 2-204(3) (A.C.A. § 4-2-204(3)).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 2 (§ 1-205), to make the section conform to the Uniform Commercial Code by correcting certain grammatical errors in the original enactment by the General Assembly.

**Comment to § 1-206 (A.C.A. § 4-1-206)**

*Prior Uniform Statutory Provision:* Section 4, Uniform Sales Act (which was based on Section 17 of the Statute of 29 Charles II).

*Changes:* Completely rewritten by this and other sections.

*Purposes:* To fill the gap left by the Statute of Frauds provisions for goods (Section 2-201 (A.C.A. § 4-2-201)), securities (Section 8-319 (A.C.A. § 4-8-319)), and security interests (Section 9-203 (A.C.A. § 4-9-203)). The Uniform Sales Act covered the sale of "choses in action"; the principal gap relates to sale of the "general intangibles" defined in Article 9 (Chapter 9) (Section 9-106 (A.C.A. § 4-9-106)) and to transactions excluded from Article 9 (Chapter 9) by Section 9-104 (A.C.A. § 4-9-104). Typical are the sale of bilateral contracts, royalty rights or the like. The informality normal to such transactions is recognized by lifting the limit for oral transactions to \$5,000. In such transactions there is often no standard of practice by which to judge, and values can rise or

drop without warning; troubling abuses are avoided when the dollar limit is exceeded by requiring that the subject-matter be reasonably identified in a signed writing which indicates that a contract for sale has been made at a defined or stated price.

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 1-207 (A.C.A. § 4-1-207)\***

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. This section provides machinery for the continuation of performance along the lines contemplated by the contract despite a pending dispute, by adopting the mercantile device of going ahead with delivery, acceptance, or payment "without prejudice," "under protest," "under reserve," "with reservation of all our rights," and the like. All of these phrases completely reserve all rights within the meaning of this section. The section therefore contemplates that limited as well as general reservations and acceptance by a party may be made "subject to satisfaction of our purchaser," "subject to acceptance by our customers," or the like.

2. This section does not add any new requirement of language of reservation where not already required by law, but merely provides a specific measure on which a party can rely as that party makes or concurs in any interim adjustment in the course of performance. It does not affect or impair the provisions of this Act such as those under which the buyer's remedies for defect survive acceptance without being expressly claimed if notice of the defects is given within a reasonable time. Nor does it disturb the policy of those cases which restrict the effect of a waiver of a defect to reasonable limits under the circumstances, even though no such reservation is expressed.

The section is not addressed to the creation or loss of remedies in the ordinary course of performance but rather to a method of procedure where one party is claiming as of right something which the other believes to be unwarranted.

3. Judicial authority was divided on the issue of whether former Section 1-207 (present subsection (1)) (A.C.A. § 4-1-207(1)) applied to an accord and satisfaction. Typically the cases involved attempts to reach an accord and satisfaction by use of a check tendered in full satisfaction of a claim. Subsection (2) of revised Section 1-207 (A.C.A. § 4-1-207(2)) resolves this conflict by stating that Section 1-207 (A.C.A. § 4-1-207) does not apply to an accord and satisfaction. Section 3-311 (A.C.A. § 4-3-311) of revised Article 3 (A.C.A. § 4-3-101 et seq.) governs if an accord and satisfaction is attempted by tender of a negotiable instrument as stated in that section. If Section 3-311 (A.C.A. § 4-3-311) does not apply, the issue of whether an accord and satisfaction has been effected is determined by the law of contract. Whether or not Section 3-311 (A.C.A. § 4-3-311) applies, Section 1-207 (A.C.A. § 4-1-207) has no application to an accord and satisfaction.

*Cross Reference:*

Section 2-607 (A.C.A. § 4-2-607).

*Definitional Cross References:*

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1991, No. 572, § 4, which added (2) to make clear that the section does not apply to an accord and satisfaction and made minor punctuation changes in (1).

**Comment to § 1-208 (A.C.A. § 4-1-208)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

The increased use of acceleration clauses either in the case of sales on credit or in time paper or in security transactions has led to some confusion in the cases as to the effect to be given to a clause which seemingly grants the power of an acceleration at the whim and caprice of one party. This Section is intended to

make clear that despite language which can be so construed and which further might be held to make the agreement void as against public policy or to make the contract illusory or too indefinite for enforcement, the clause means that the option is to be exercised only in the good faith belief that the prospect of payment or performance is impaired.

Obviously this section has no application to demand instruments or obligations



whose very nature permits call at any time with or without reason. This section applies only to an agreement or to paper which in the first instance is payable at a future date.

*Definitional Cross References:*

“Burden of establishing”. Section 1-201 (A.C.A. § 4-1-201).

“Good faith”. Section 1-201 (A.C.A. § 4-1-201).

“Party”. Section 1-201 (A.C.A. § 4-1-201).

“Term”. Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 1-209 (A.C.A. § 4-1-209)**

*Source:* New York.

*Prior Uniform Statutory Provision:* None.

*Reason for Change:* The drafting history of Article 9 (Chapter 9) makes it clear that there was no intention to cover agreements by which the rights of one unsecured creditor are subordinated to the rights of another unsecured creditor of a common debtor. Nevertheless, since in insolvency proceedings dividends otherwise payable to a subordinated creditor are turned over to the superior creditor, fears have been expressed that a subordination agreement might be treated as a “security agreement” creating a “security interest” in property of the subordinated creditor, and that inappropriate provisions of Article 9 (Chapter 9) might be applied. This optional section is intended to allay such fears by making an explicit declaration that a subordination agreement does not of itself create a security interest. Nothing in this section prevents the creation of a security interest in such a case when the parties to the agreement so intend.

*Purposes:*

1. Billions of dollars of subordinated debt are held by the public and by institutional investors. Commonly, the subordinated debt is subordinated on issue or acquisition and is evidenced by an investment security or by a negotiable or non-negotiable note. Debt is also sometimes subordinated after it arises, either by agreement between the subordinating creditor and the debtor, by agreement between two creditors of the same debtor, or by agreement of all three parties. The subordinated creditor may be a stockholder or other “insider” interested in the common debtor; the subordinated debt may consist of accounts or other rights to payment not evidenced by any instrument. All such cases are included in the

terms “subordinated obligation,” “subordination,” and “subordinated creditor.”

2. Subordination agreements are enforceable between the parties as contracts; and in the bankruptcy of the common debtor dividends otherwise payable to the subordinated creditor are turned over to the superior creditor. This “turn-over” practice has on occasion been explained in terms of “equitable lien,” “equitable assignment,” or “constructive trust,” but whatever the label the practice is essentially an equitable remedy and does not mean that there is a transaction “intended to create a security interest,” a “sale of accounts, contract rights or chattel paper,” or a “security interest created by contract,” within the meaning of Section 9-102 (A.C.A. § 4-9-102). On the other hand, nothing in this section prevents one creditor from assigning his rights to another creditor of the same debtor in such a way as to create a security interest within Article 9 (Chapter 9), where the parties so intend.

3. The last sentence of this section is intended to negate any implication that the section changes the law. It is intended to be declaratory of preexisting law. Both the history and the text of Article 9 (Chapter 9) make it clear that it was not intended to cover subordination agreements. The provisions of Section 9-203 (A.C.A. § 4-9-203) for signature by the “debtor” would be entirely unworkable if read to require signature by public holders of subordinated investment securities. The priorities, filing provisions and remedies on default provided by Article 9 (Chapter 9) would also be largely inappropriate in many situations. The precautionary language of Section 9-316 (A.C.A. § 4-9-316) preserving subordination of priority by agreement between secured parties points to the conclusion that similar arrangements among unsecured lend-

ers are not covered unless otherwise within the scope of the Article (Chapter).

4. The enforcement of subordination agreements is largely left to supplementary principles under Section 1-103 (A.C.A. § 4-1-103). If the subordinated debt is evidenced by an investment security, Section 8-202(1) (A.C.A. § 4-8-202(1)) authorizes enforcement against purchasers on terms stated or referred to on the security. If the fact of subordination is noted on a negotiable instrument, a holder under Sections 3-302 (A.C.A. § 4-3-302) and 3-306 (A.C.A. § 4-3-306) is subject to the term because notice precludes him from taking free of the subordination. Sections 3-302(3)(a) (A.C.A. § 4-3-302(3)(a)), 3-306 (A.C.A. § 4-3-306) and 8-317

(A.C.A. § 4-8-317) severely limit the rights of levying creditors of a subordinated creditor in such cases.

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

## ARTICLE 2

(A.C.A. § 4-2-101 et seq.)

### Comment to § 2-101 (A.C.A. § 4-2-101)\*

This Article (Chapter) is a complete revision and modernization of the Uniform Sales Act which was promulgated by the National Conference of Commissioners on Uniform State Laws in 1906 and has been adopted in 34 states and Alaska, the District of Columbia and Hawaii.

The coverage of the present Article (Chapter) is much more extensive than that of the old Sales Act and extends to the various bodies of case law which have been developed both outside of and under the latter.

The arrangement of the present Article (Chapter) is in terms of contract for sale and the various steps of its performance. The legal consequences are stated as following directly from the contract and ac-

tion taken under it without resorting to the idea of when property or title passed or was to pass as being the determining factor. The purpose is to avoid making practical issues between practical men turn upon the location of an intangible something, the passing of which no man can prove by evidence and to substitute for such abstractions proof of words and actions of a tangible character.

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\*This section was amended by Acts 1967, No. 303, § 3, to make it conform to the Uniform Commercial Code Section by adding language that was omitted from the original enactment by the Arkansas General Assembly.

### Comment to § 2-102 (A.C.A. § 4-2-102)

*Prior Uniform Statutory Provision:* Section 75, Uniform Sales Act.

*Changes:* Section 75 has been rephrased.

*Purposes of Changes and New Matter:*  
To make it clear that:

The Article (Chapter) leaves substantially unaffected the law relating to purchase money security such as conditional sale or chattel mortgage though it regulates the general sales aspects of such transactions. "Security transaction" is

used in the same sense as in the Article (Chapter) on Secured Transactions (Article 9 (Chapter 9)).

*Cross Reference:*

Article 9 (Chapter 9).

*Definitional Cross References:*

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).



"Present sale". Section 2-106 (A.C.A. § 4-2-106).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

### Comment to § 2-103 (A.C.A. § 4-2-103)

*Prior Uniform Statutory Provision:* Subsection (1) (A.C.A. § 4-2-103(1)); Section 76, Uniform Sales Act.

#### *Changes:*

The definitions of "buyer" and "seller" have been slightly rephrased, the reference in Section 76 of the prior Act to "Any legal successor in interest of such person" being omitted. The definition of "receipt" is new.

#### *Purposes of Changes and New Matter:*

1. The phrase "any legal successor in interest of such person" has been eliminated since Section 2-210 (A.C.A. § 4-2-210) of this Article (Chapter), which limits some types of delegation of performance on assignment of a sales contract, makes it clear that not every such successor can be safely included in the definition. In every ordinary case, however, such successors are as of course included.

2. "Receipt" must be distinguished from delivery particularly in regard to the problems arising out of shipment of goods, whether or not the contract calls for making delivery by way of documents of title, since the seller may frequently fulfill his obligations to "deliver" even though the buyer may never "receive" the goods. Delivery with respect to documents of title is defined in Article 1 (Chapter 1) and requires transfer of physical delivery. Otherwise the many divergent incidents of delivery are handled incident by incident.

#### *Cross References:*

Point 1: See Section 2-210 (A.C.A. § 4-2-210) and Comment thereon.

Point 2: Section 1-201 (A.C.A. § 4-1-201).

#### *Definitional Cross Reference:*

"Person". Section 1-201 (A.C.A. § 4-1-201).

### Comment to § 2-104 (A.C.A. § 4-2-104)

*Prior Uniform Statutory Provision:* None. But see Sections 15(2), (5), 16(c), 45(2) and 71, Uniform Sales Act, and Sections 35 and 37, Uniform Bills of Lading Act for examples of the policy expressly provided for in this Article.

#### *Purposes:*

1. This Article (Chapter) assumes that transactions between professionals in a given field require special and clear rules which may not apply to a casual or inexperienced seller or buyer. It thus adopts a policy of expressly stating rules applicable "between merchants" and "as against a merchant", wherever they are needed instead of making them depend upon the circumstances of each case as in the statutes cited above. This section lays the foundation of this policy by defining those who are to be regarded as professionals or "merchants" and by stating when a transaction is deemed to be "between merchants".

2. The term "merchant" as defined here roots in the "law merchant" concept of a professional in business. The professional

status under the definition may be based upon specialized knowledge as to the goods, specialized knowledge as to business practices, or specialized knowledge as to both and which kind of specialized knowledge may be sufficient to establish the merchant status is indicated by the nature of the provisions.

The special provisions as to merchants appear only in this Article (Chapter) and they are of three kinds. Sections 2-201(2) (A.C.A. § 4-2-201(2)), 2-205 (A.C.A. § 4-2-205), 2-207 (A.C.A. § 4-2-207) and 2-209 (A.C.A. § 4-2-209) dealing with the statute of frauds, firm offers, confirmatory memoranda and modification rest on normal business practices which are or ought to be typical of and familiar to any person in business. For purposes of these sections almost every person in business would, therefore, be deemed to be a "merchant" under the language "who ... by his occupation holds himself out as having knowledge or skill peculiar to the practices ... involved in the transaction ...," since the practices involved in the transaction are nonspecialized business practices such as

answering mail. In this type of provision, banks or even universities, for example, well may be "merchants." But even these sections only apply to a merchant in his mercantile capacity; a lawyer or bank president buying fishing tackle for his own use is not a merchant.

On the other hand, in Section 2-314 (A.C.A. § 4-2-314) on the warranty of merchantability, such warranty is implied only "if the seller is a merchant with respect to goods of that kind." Obviously this qualification restricts the implied warranty to a much smaller group than everyone who is engaged in business and requires a professional status as to particular kinds of goods. The exception in Section 2-402(2) (A.C.A. § 4-2-402(2)) for retention of possession by a merchant-seller falls in the same class; as does Section 2-403(2) (A.C.A. § 4-2-403(2)) on entrusting of possession to a merchant "who deals in goods of that kind".

A third group of sections includes 2-103(1)(b) (A.C.A. § 4-2-103(1)(b)), which provides that in the case of a merchant "good faith" includes observance of reasonable commercial standards of fair dealing in the trade; 2-327(1)(c) (A.C.A. § 4-2-327(1)(c)), 2-603 (A.C.A. § 4-2-603) and 2-605 (A.C.A. § 4-2-605), dealing with responsibilities of merchant buyers to follow seller's instructions, etc.; 2-509 (A.C.A. § 4-2-509) on risk of loss, and 2-609 (A.C.A. § 4-2-609) on adequate assurance of performance. This group of sections applies to persons who are merchants under either the "practices" or the "goods" aspect of the definition of merchant.

3. The "or to whom such knowledge or skill may be attributed by his employment of an agent or broker ..." clause of the definition of merchant means that even persons such as universities, for example, can come within the definition of merchant if they have regular purchasing departments or business personnel who are familiar with business practices and who are equipped to take any action required.

#### *Cross References:*

Point 1: See Sections 1-102 (A.C.A. § 4-1-102) and 1-203 (A.C.A. § 4-1-203).

Point 2: See Sections 2-314 (A.C.A. § 4-2-314), 2-315 (A.C.A. § 4-2-315) and 2-320 (A.C.A. § 4-2-320) to 2-325 (A.C.A. § 4-2-325) of this Article (Chapter), and Article 9 (Chapter 9).

#### *Definitional Cross References:*

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

#### **Comment to § 2-105 (A.C.A. § 4-2-105)**

*Prior Uniform Statutory Provision:* Subsections (1), (2), (3) and (4) — Sections 5, 6 and 76, Uniform Sales Act; Subsections (5) and (6) — none.

*Changes:* Rewritten.

#### *Purposes of Changes and New Matter:*

1. Subsection (1) (A.C.A. § 4-2-105(1)) on "goods": The phraseology of the prior uniform statutory provision has been changed so that:

The definition of goods is based on the concept of movability and the term "chattels personal" is not used. It is not intended to deal with things which are not

fairly identifiable as movables before the contract is performed.

Growing crops are included within the definition of goods since they are frequently intended for sale. The concept of "industrial" growing crops has been abandoned, for under modern practices fruit, perennial hay, nursery stock and the like must be brought within the scope of this Article (Chapter). The young of animals are also included expressly in this definition since they, too, are frequently intended for sale and may be contracted for before birth. The period of gestation of domestic animals is such that the provisions of the section on identification can



apply as in the case of crops to be planted. The reason of this definition also leads to the inclusion of a wool crop or the like as "goods" subject to identification under this Article (Chapter).

The exclusion of "money in which the price is to be paid" from the definition of goods does not mean that foreign currency which is included in the definition of money may not be the subject matter of a sales transaction. Goods is intended to cover the sale of money when money is being treated as a commodity but not to include it when money is the medium of payment.

As to contracts to sell timber, minerals, or structures to be removed from the land Section 2-107(1) (A.C.A. § 4-2-107) (Goods to be severed from Realty: recording-) controls.

The use of the word "fixtures" is avoided in view of the diversity of definitions of that term. This Article (Chapter) in including within its scope "things attached to realty" adds the further test that they must be capable of severance without material harm thereto. As between the parties any identified things which falls within that definition becomes "goods" upon the making of the contract for sale.

"Investment securities" are expressly excluded from the coverage of this Article (Chapter). It is not intended by this exclusion, however, to prevent the application of a particular section of this Article (Chapter) by analogy to securities (as was done with the Original Sales Act in *Agar v. Orda*, 264 N.Y. 248, 190 N.E. 479, 99 A.L.R. 269 (1934)) when the reason of that section makes such application sensible and the situation involved is not covered by the Article (Chapter) of this Act dealing specifically with such securities (Article 8 (Chapter 8)).

2. References to the fact that a contract for sale can extend to future or contingent goods and that ownership in common fol-

lows the sale of a part interest have been omitted here as obvious without need for expression; hence no inference to negate these principles should be drawn from their omission.

3. Subsection (4) (A.C.A. § 4-2-105(1)) does not touch the question of how far an appropriation of a bulk of fungible goods may or may not satisfy the contract for sale.

4. Subsections (5) (A.C.A. § 4-2-105(5)) and (6) (A.C.A. § 4-2-105(6)) on "lot" and "commercial unit" are introduced to aid in the phrasing of later sections.

5. The question of when an identification of goods takes place is determined by the provisions of Section 2-501 (A.C.A. § 4-2-501) and all that this section says is what kinds of goods may be the subject of a sale.

#### *Cross References:*

Point 1: Sections 2-107 (A.C.A. § 4-2-107), 2-201 (A.C.A. § 4-2-201), 2-501 (A.C.A. § 4-2-501) and Article 8 (Chapter 8).

Point 5: Section 2-501 (A.C.A. § 4-2-501).

See also Section 1-201 (A.C.A. § 4-1-201).

#### *Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Fungible". Section 1-201 (A.C.A. § 4-1-201).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Present sale". Section 2-106 (A.C.A. § 4-2-106).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### **Comment to § 2-106 (A.C.A. § 4-2-106)**

*Prior Uniform Statutory Provision:* Subsection (1) (A.C.A. § 4-2-106(1)) — Section 1(1) and (2), Uniform Sales Act; Subsection (2) (A.C.A. § 4-2-106(2)) — none, but subsection generally continues policy of Sections 11, 44 and 69, Uniform Sales Act;

Subsections (3) (A.C.A. § 4-2-106(3)) and (4) (A.C.A. § 4-2-106(4)) — none.

*Changes:* Completely rewritten.

*Purposes of Changes and New Matter:*

1. Subsection (1) (A.C.A. § 4-2-106(1)):

"Contract for sale" is used as a general concept throughout this Article (Chapter), but the rights of the parties do not vary according to whether the transaction is a present sale or a contract to sell unless the Article (Chapter) expressly so provides.

2. Subsection (2) (A.C.A. § 4-2-106(2)): It is in general intended to continue the policy of requiring exact performance by the seller of his obligations as a condition to his right to require acceptance. However, the seller is in part safeguarded against surprise as a result of sudden technicality on the buyer's part by the provisions of Section 2-508 (A.C.A. § 4-2-508) on seller's cure of improper tender or delivery. Moreover, usage of trade frequently permits commercial leeways in performance and the language of the agreement itself must be read in the light of such custom or usage and also, prior course of dealing, and in a long term contract, the course of performance.

3. Subsections (3) (A.C.A. § 4-2-106(3)) and (4) (A.C.A. § 4-2-106(4)): These subsections are intended to make clear the

distinction carried forward throughout this Article (Chapter) between termination and cancellation.

*Cross References:*

Point 2: Sections 1-203 (A.C.A. § 4-1-203), 1-205 (A.C.A. § 4-1-205), 2-208 (A.C.A. § 4-2-208) and 2-508 (A.C.A. § 4-2-508).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**1972 Official Comment to § 2-107 (A.C.A. § 4-2-107)\***

*Prior Uniform Statutory Provision:* See Section 76, Uniform Sales Act on prior policy; Section 7, Uniform Conditional Sales Act.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-2-107(1)). Notice that this subsection applies only if the minerals or structures "are to be severed by the seller". If the buyer is to sever, such transactions are considered contracts affecting land and all problems of the Statute of Frauds and of the recording of land rights apply to them. Therefore, the Statute of Frauds section of this Article (Chapter) does not apply to such contracts though they must conform to the Statute of Frauds affecting the transfer of interests in land.

2. Subsection (2) (A.C.A. § 4-2-107(2)). "Things attached" to the realty which can be severed without material harm are goods within this Article (Chapter) regardless of who is to effect the severance. The word "fixtures" has been avoided because of the diverse definitions of this term, the test of "severance without material harm" being substituted.

The provision in subsection (3) (A.C.A.

§ 4-2-107(3)) for recording such contracts is within the purview of this Article (Chapter) since it is a means of preserving the buyer's rights under the contract of sale.

3. The security phases of things attached to or to become attached to realty are dealt with in the Article (Chapter) on Secured Transactions (Article 9 (Chapter 9)) and it is to be noted that the definition of goods in that Article (Chapter) differs from the definition of goods in this Article (Chapter).

However, both Articles (Chapters) treat as goods growing crops and also timber to be cut under a contract of severance.

*Cross References:*

Point 1: Section 2-201 (A.C.A. § 4-2-201).

Point 2: Section 2-105 (A.C.A. § 4-2-105).

Point 3: Article 9 (Chapter 9) and Section 9-105 (A.C.A. § 4-9-105).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).



"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Present sale". Section 2-106 (A.C.A. § 4-2-106).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

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\*This section was amended by Acts 1973 No. 116, § 3, to incorporate the 1972 changes to this Uniform Commercial Code section.

### Comment to § 2-201 (A.C.A. § 4-2-201)

*Prior Uniform Statutory Provision:* Section 4, Uniform Sales Act (which was based on Section 17 of the Statute of 29 Charles II).

*Changes:* Completely rephrased; restricted to sale of goods. See also Sections 1-206 (A.C.A. § 4-1-206), 8-319 (A.C.A. § 4-8-319) and 9-203 (A.C.A. § 4-9-203).

*Purposes of Changes:* The changed phraseology of this section is intended to make it clear that:

1. The required writing need not contain all the material terms of the contract and such material terms as are stated need not be precisely stated. All that is required is that the writing afford a basis for believing that the offered oral evidence rests on a real transaction. It may be written in lead pencil on a scratch pad. It need not indicate which party is the buyer and which the seller. The only term which must appear is the quantity term which need not be accurately stated but recovery is limited to the amount stated. The price, time and place of payment or delivery, the general quality of the goods, or any particular warranties may all be omitted.

Special emphasis must be placed on the permissibility of omitting the price term in view of the insistence of some courts on the express inclusion of this term even where the parties have contracted on the basis of a published price list. In many valid contracts for sale the parties do not mention the price in express terms, the buyer being bound to pay and the seller to accept a reasonable price which the trier of the fact may well be trusted to determine. Again frequently the price is not mentioned since the parties have based their agreement on a price list or catalogue known to both of them and this list serves as an efficient safeguard against

perjury. Finally, "market" prices and valuations that are current in the vicinity constitute a similar check. Thus if the price is not stated in the memorandum it can normally be supplied without danger of fraud. Of course if the "price" consists of goods rather than money the quantity of goods must be stated.

Only three definite and invariable requirements as to the memorandum are made by this subsection. First, it must evidence a contract for the sale of goods; second, it must be "signed", a word which includes any authentication which identifies the party to be charged; and third, it must specify a quantity.

2. "Partial performance" as a substitute for the required memorandum can validate the contract only for the goods which have been accepted or for which payment has been made and accepted.

Receipt and acceptance either of goods or of the price constitutes an unambiguous overt admission by both parties that a contract actually exists. If the court can make a just apportionment, therefore, the agreed price of any goods actually delivered can be recovered without a writing or, if the price has been paid, the seller can be forced to deliver an apportionable part of the goods. The overt actions of the parties make admissible evidence of the other terms of the contract necessary to a just apportionment. This is true even though the actions of the parties are not in themselves inconsistent with a different transaction such as a consignment for resale or a mere loan of money.

Part performance by the buyer requires the delivery of something by him that is accepted by the seller as such performance. Thus, part payment may be made by money or check, accepted by the seller. If the agreed price consists of goods or

services, then they must also have been delivered and accepted.

3. Between merchants, failure to answer a written confirmation of a contract within ten days of receipt is tantamount to a writing under subsection (2) (A.C.A. § 4-2-201(2)) and is sufficient against both parties under subsection (1) (A.C.A. § 4-2-201(1)). The only effect, however, is to take away from the party who fails to answer the defense of the Statute of Frauds; the burden of persuading the trier of fact that a contract was in fact made orally prior to the written confirmation is unaffected. Compare the effect of a failure to reply under Section 2-207 (A.C.A. § 4-2-207).

4. Failure to satisfy the requirements of this section does not render the contract void for all purposes, but merely prevents it from being judicially enforced in favor of a party to the contract. For example, a buyer who takes possession of goods as provided in an oral contract which the seller has not meanwhile repudiated, is not a trespasser. Nor would the Statute of Frauds provisions of this section be a defense to a third person who wrongfully induces a party to refuse to perform an oral contract, even though the injured party cannot maintain an action for damages against the party so refusing to perform.

5. The requirement of "signing" is discussed in the comment to Section 1-201 (A.C.A. § 4-1-201).

6. It is not necessary that the writing be delivered to anybody. It need not be signed or authenticated by both parties but it is, of course, not sufficient against one who has not signed it. Prior to a dispute no one can determine which party's signing of the memorandum may be necessary but from the time of contracting

each party should be aware that to him it is signing by the other which is important.

7. If the making of a contract is admitted in court, either in a written pleading, by stipulation or by oral statement before the court, no additional writing is necessary for protection against fraud. Under this section it is no longer possible to admit the contract in court and still treat the Statute as a defense. However, the contract is not thus conclusively established. The admission so made by a party is itself evidential against him of the truth of the facts so admitted and of nothing more; as against the other party, it is not evidential at all.

#### *Cross References:*

See Sections 1-201 (A.C.A. § 4-1-201), 2-202 (A.C.A. § 4-2-202), 2-207 (A.C.A. § 4-2-207), 2-209 (A.C.A. § 4-2-209) and 2-304 (A.C.A. § 4-2-304).

#### *Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Between merchants". Section 2-104 (A.C.A. § 4-2-104).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### **Comment to § 2-202 (A.C.A. § 4-2-202)**

*Prior Uniform Statutory Provision:* None.

#### *Purposes:*

1. This section definitely rejects:

(a) Any assumption that because a writing has been worked out which is final on some matters, it is to be taken as including all the matters agreed upon;

(b) The premise that the language used has the meaning attributable to such language by rules of construction existing in

the law rather than the meaning which arises out of the commercial context in which it was used; and

(c) The requirement that a condition precedent to the admissibility of the type of evidence specified in paragraph (a) is an original determination by the court that the language used is ambiguous.

2. Paragraph (a) makes admissible evidence of course of dealing, usage of trade



and course of performance to explain or supplement the terms of any writing stating the agreement of the parties in order that the true understanding of the parties as to the agreement may be reached. Such writings are to be read on the assumption that the course of prior dealings between the parties and the usages of trade were taken for granted when the document was phrased. Unless carefully negated they have become an element of the meaning of the words used. Similarly, the course of actual performance by the parties is considered the best indication of what they intended the writing to mean.

3. Under paragraph (b) consistent additional terms, not reduced to writing, may be proved unless the court finds that the writing was intended by both parties as a complete and exclusive statement of all the terms. If the additional terms are such that, if agreed upon, they would certainly have been included in the document in the

view of the court, then evidence of their alleged making must be kept from the trier of fact.

*Cross References:*

Point 3: Sections 1-205 (A.C.A. § 4-1-205), 2-207 (A.C.A. § 4-2-207), 2-302 (A.C.A. § 4-2-302) and 2-316 (A.C.A. § 4-2-316).

*Definitional Cross References:*

"Agreed" and "agreement". Section 1-201 (A.C.A. § 4-1-201).

"Course of dealing". Section 1-205 (A.C.A. § 4-1-205).

"Parties". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Usage of trade". Section 1-205 (A.C.A. § 4-1-205).

"Written" and "writing". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-203 (A.C.A. § 4-2-203)**

*Prior Uniform Statutory Provision:* Section 3, Uniform Sales Act.

*Changes:* Portion pertaining to "seals" rewritten.

*Purposes of Changes:*

1. This section makes it clear that every effect of the seal which relates to "sealed instruments" as such is wiped out insofar as contracts for sale are concerned. However, the substantial effects of a seal, except extension of the period of limitations, may be had by appropriate drafting as in the case of firm offers (see Section 2-205 (A.C.A. § 4-2-205)).

2. This section leaves untouched any aspects of a seal which relate merely to signatures or to authentication of execution and the like. Thus, a statute providing that a purported signature gives prima facie evidence of its own authenticity or that a signature gives prima facie

evidence of consideration is still applicable to sales transactions even though a seal may be held to be a signature within the meaning of such a statute. Similarly, the authorized affixing of a corporate seal bearing the corporate name to a contractual writing purporting to be made by the corporation may have effect as a signature without any reference to the law of sealed instruments.

*Cross Reference:*

Point 1: Section 2-205 (A.C.A. § 4-2-205).

*Definitional Cross References:*

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-204 (A.C.A. § 4-2-204)**

*Prior Uniform Statutory Provision:* Sections 1 and 3, Uniform Sales Act.

*Changes:* Completely rewritten by this and other sections of this Article (Chapter).

*Purposes of Changes:*

Subsection (1) (A.C.A. § 4-2-204(1)) continues without change the basic policy of recognizing any manner of expression of agreement, oral, written or otherwise. The legal effect of such an agreement is, of

course, qualified by other provisions of this Article.

Under subsection (1) (A.C.A. § 4-2-204(1)) appropriate conduct by the parties may be sufficient to establish an agreement. Subsection (2) (A.C.A. § 4-2-204(2)) is directed primarily to the situation where the interchanged correspondence does not disclose the exact point at which the deal was closed, but the actions of the parties indicate that a binding obligation has been undertaken.

Subsection (3) (A.C.A. § 4-2-204(3)) states the principle as to "open terms" underlying later sections of the Article (Chapter). If the parties intend to enter into a binding agreement, this subsection recognizes that agreement as valid in law, despite missing terms, if there is any reasonably certain basis for granting a remedy. The test is not certainty as to what the parties were to do nor as to the exact amount of damages due the plaintiff. Nor is the fact that one or more terms are left to be agreed upon enough of itself to defeat an otherwise adequate agreement. Rather, commercial standards on the point of "indefiniteness" are intended to be applied, this Act making provision elsewhere for missing terms needed for performance, open price, remedies and the like.

The more terms the parties leave open, the less likely it is that they have intended to conclude a binding agreement, but their actions may be frequently conclusive on the matter despite the omissions.

#### *Cross References:*

Subsection (1) (A.C.A. § 4-2-204(1)): Sections 1-103 (A.C.A. § 4-1-103), 2-201 (A.C.A. § 4-2-201) and 2-302 (A.C.A. § 4-2-302).

Subsection (2) (A.C.A. § 4-2-204(2)): Sections 2-205 through 2-209 (A.C.A. §§ 4-2-205 through 4-2-209).

Subsection (3) (A.C.A. § 4-2-204(3)): See part 3.

#### *Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

### **Comment to § 2-205 (A.C.A. § 4-2-205)**

*Prior Uniform Statutory Provision:* Sections 1 and 3, Uniform Sales Act.

*Changes:* Completely rewritten by this and other sections of this Article (Chapter).

#### *Purposes of Changes:*

1. This section is intended to modify the former rule which required that "firm offers" be sustained by consideration in order to bind, and to require instead that they must merely be characterized as such and expressed in signed writings.

2. The primary purpose of this section is to give effect to the deliberate intention of a merchant to make a current firm offer binding. The deliberation is shown in the case of an individualized document by the merchant's signature to the offer, and in the case of an offer included on a form supplied by the other party to the transaction by the separate signing of the par-

ticular clause which contains the offer. "Signed" here also includes authentication but the reasonableness of the authentication herein allowed must be determined in the light of the purpose of the section. The circumstances surrounding the signing may justify something less than a formal signature or initialing but typically the kind of authentication involved here would consist of a minimum of initialing of the clause involved. A handwritten memorandum on the writer's letterhead purporting in its terms to "confirm" a firm offer already made would be enough to satisfy this section, although not subscribed, since under the circumstances it could not be considered a memorandum of mere negotiation and it would adequately show its own authenticity. Similarly, an authorized telegram will suffice, and this is true even though the original draft contained only a typewritten signature. However, despite settled courses of deal-



ing or usages of the trade whereby firm offers are made by oral communication and relied upon without more evidence, such offers remain revocable under this Article (Chapter) since authentication by a writing is the essence of this section.

3. This section is intended to apply to current "firm" offers and not to long term options, and an outside time limit of three months during which such offers remain irrevocable has been set. The three month period during which firm offers remain irrevocable under this section need not be stated by days or by date. If the offer states that it is "guaranteed" or "firm" until the happening of a contingency which will occur within the three month period, it will remain irrevocable until that event. A promise made for a longer period will operate under this section to bind the offeror only for the first three months of the period but may of course be renewed. If supported by consideration it may continue for as long as the parties specify. This section deals only with the offer which is not supported by consideration.

4. Protection is afforded against the inadvertent signing of a firm offer when contained in a form prepared by the offeree by requiring that such a clause be

separately authenticated. If the offer clause is called to the offeror's attention and he separately authenticates it, he will be bound; Section 2-302 (A.C.A. § 4-2-302) may operate, however, to prevent an unconscionable result which otherwise would flow from other terms appearing in the form.

5. Safeguards are provided to offer relief in the case of material mistake by virtue of the requirement of good faith and the general law of mistake.

*Cross References:*

Point 1: Section 1-102 (A.C.A. § 4-1-102).

Point 2: Section 1-102 (A.C.A. § 4-1-102).

Point 3: Section 2-201 (A.C.A. § 4-2-201).

Point 5: Section 2-302 (A.C.A. § 4-2-302).

*Definitional Cross References:*

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Merchant". Section 2-104 (A.C.A. § 4-2-104).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-206 (A.C.A. § 4-2-206)**

*Prior Uniform Statutory Provision:* Sections 1 and 3, Uniform Sales Act.

*Changes:* Completely rewritten in this and other sections of this Article (Chapter).

*Purposes of Changes:* To make it clear that:

1. Any reasonable manner of acceptance is intended to be regarded as available unless the offeror has made quite clear that it will not be acceptable. Former technical rules as to acceptance, such as requiring that telegraphic offers be accepted by telegraphed acceptance, etc., are rejected and a criterion that the acceptance be "in any manner and by any medium reasonable under the circumstances," is substituted. This section is intended to remain flexible and its applicability to be enlarged as new media of communication develop or as the more time-saving present day media come into general use.

2. Either shipment or a prompt promise to ship is made a proper means of acceptance of an offer looking to current shipment. In accordance with ordinary commercial understanding the section interprets an order looking to current shipment as allowing acceptance either by actual shipment or by a prompt promise to ship and rejects the artificial theory that only a single mode of acceptance is normally envisaged by an offer. This is true even though the language of the offer happens to be "ship at once" or the like. "Shipment" is here used in the same sense as in Section 2-504 (A.C.A. § 4-2-504); it does not include the beginning of delivery by the seller's own truck or by messenger. But loading on the seller's own truck might be a beginning of performance under subsection (2) (A.C.A. § 4-2-206(2)).

3. The beginning of performance by an offeree can be effective as acceptance so as to bind the offeror only if followed within a reasonable time by notice to the offeror.



Such a beginning of performance must unambiguously express the offeree's intention to engage himself. For the protection of both parties it is essential that notice follow in due course to constitute acceptance. Nothing in this section however bars the possibility that under the common law performance begun may have an intermediate effect of temporarily barring revocation of the offer, or at the offeror's option, final effect in constituting acceptance.

4. Subsection (1)(b) (A.C.A. § 4-2-206(1)(b)) deals with the situation where a shipment made following an order is shown by a notification of shipment to be referable to that order but has a defect. Such a non-conforming shipment is normally to be understood as intended to close the bargain, even though it proves to

have been at the same time a breach. However, the seller by stating that the shipment is non-conforming and is offered only as an accommodation to the buyer keeps the shipment or notification from operating as an acceptance.

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conforming". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

**Comment to § 2-207 (A.C.A. § 4-2-207)**

*Prior Uniform Statutory Provision:* Sections 1 and 3, Uniform Sales Act.

*Changes:* Completely rewritten by this and other sections of this Article (Chapter).

*Purposes of Changes:*

1. This section is intended to deal with two typical situations. The one is where an agreement has been reached either orally or by informal correspondence between the parties and is followed by one or both of the parties sending formal acknowledgments or memoranda embodying the terms so far as agreed upon and adding terms not discussed. The other situation is one in which a wire or letter expressed and intended as the closing or confirmation of an agreement adds further minor suggestions or proposals such as "ship by Tuesday," "rush," "ship draft against bill of lading inspection allowed," or the like.

2. Under this Article (Chapter) a proposed deal which in commercial understanding has in fact been closed is recognized as a contract. Therefore, any additional matter contained either in the writing intended to close the deal or in a later confirmation falls within subsection (2) (A.C.A. § 4-2-207(2)) and must be regarded as a proposal for an added term unless the acceptance is made conditional on the acceptance of the additional terms.

3. Whether or not additional or different terms will become part of the agreement depends upon the provisions of subsection (2) (A.C.A. § 4-2-207(2)). If they are such as materially to alter the original bargain, they will not be included unless expressly agreed to by the other party. If, however, they are terms which would not so change the bargain they will be incorporated unless notice of objection to them has already been given or is given within a reasonable time.

4. Examples of typical clauses which would normally "materially alter" the contract and so result in surprise or hardship if incorporated without express awareness by the other party are: a clause negating such standard warranties as that of merchantability or fitness for a particular purpose in circumstances in which either warranty normally attaches; a clause requiring a guaranty of 90% or 100% deliveries in a case such as a contract by cannery, where the usage of the trade allows greater quantity leeways; a clause reserving to the seller the power to cancel upon the buyer's failure to meet any invoice when due; a clause requiring that complaints be made in a time materially shorter than customary or reasonable.

5. Examples of clauses which involve no element of unreasonable surprise and which therefore are to be incorporated in the contract unless notice of objection is

seasonably given are: a clause setting forth and perhaps enlarging slightly upon the seller's exemption due to supervening causes beyond his control, similar to those covered by the provision of this Article (Chapter) on merchant's excuse by failure of presupposed conditions or a clause fixing in advance any reasonable formula of proration under such circumstances; a clause fixing a reasonable time for complaints within customary limits, or in the case of a purchase for sub-sale, providing for inspection by the sub-purchaser; a clause providing for interest on overdue invoices or fixing the seller's standard credit terms where they are within the range of trade practice and do not limit any credit bargained for; a clause limiting the right of rejection for defects which fall within the customary trade tolerances for acceptance "with adjustment" or otherwise limiting remedy in a reasonable manner (see Sections 2-718 (A.C.A. § 4-2-718) and 2-719 (A.C.A. § 4-2-719)).

6. If no answer is received within a reasonable time after additional terms are proposed, it is both fair and commercially sound to assume that their inclusion has been assented to. Where clauses on confirming forms sent by both parties conflict each party must be assumed to object to a clause of the other conflicting with one on the confirmation sent by himself. As a result the requirement that there be notice of objection which is found in subsection (2) (A.C.A. § 4-2-207(2)) is satisfied and the conflicting terms do not become a

part of the contract. The contract then consists of the terms originally expressly agreed to, terms on which the confirmations agree, and terms supplied by this Act, including subsection (2) (A.C.A. § 4-2-207(2)).

#### *Cross References:*

See generally Section 2-302 (A.C.A. § 4-2-302).

Point 5: Sections 2-513 (A.C.A. § 4-2-513), 2-602 (A.C.A. § 4-2-602), 2-607 (A.C.A. § 4-2-607), 2-609 (A.C.A. § 4-2-609), 2-612 (A.C.A. § 4-2-612), 2-614 (A.C.A. § 4-2-614), 2-615 (A.C.A. § 4-2-615), 2-616 (A.C.A. § 4-2-616), 2-718 (A.C.A. § 4-2-718) and 2-719 (A.C.A. § 4-2-719).

Point 6: Sections 1-102 (A.C.A. § 4-1-102) and 2-104 (A.C.A. § 4-2-104).

#### *Definitional Cross References:*

"Between merchants". Section 2-104 (A.C.A. § 4-2-104).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

### **Comment to § 2-208 (A.C.A. § 4-2-208)**

*Prior Uniform Statutory Provision:* No such general provision but concept of this section recognized by terms such as "course of dealing," "the circumstances of the case," "the conduct of the parties," etc., in Uniform Sales Act.

#### *Purposes:*

1. The parties themselves know best what they have meant by their words of agreement and their action under that agreement is the best indication of what that meaning was. This section thus rounds out the set of factors which determines the meaning of the "agreement" and therefore also of the "unless otherwise agreed" qualification to various provisions of this Article (Chapter).

2. Under this section a course of performance is always relevant to determine the meaning of the agreement. Express mention of course of performance elsewhere in this Article (Chapter) carries no contrary implication when there is a failure to refer to it in other sections.

3. Where it is difficult to determine whether a particular act merely sheds light on the meaning of the agreement or represents a waiver of a term of the agreement, the preference is in favor of "waiver" whenever such construction, plus the application of the provisions on the reinstatement of rights waived (see Section 2-209 (A.C.A. § 4-2-209)), is needed to preserve the flexible character of commer-



cial contracts and to prevent surprise or other hardship.

4. A single occasion of conduct does not fall within the language of this section but other sections such as the ones on silence after acceptance and failure to specify particular defects can affect the parties' rights on a single occasion (see Sections 2-605 (A.C.A. § 4-2-605) and 2-607 (A.C.A. § 4-2-607)).

### Comment to § 2-209 (A.C.A. § 4-2-209)

*Prior Uniform Statutory Provision:* Subsection (1) (A.C.A. § 4-2-209(1)) — Compare Section 1, Uniform Written Obligations Act; Subsections (2) to (5) (A.C.A. §§ 4-2-209(2) to 4-2-209(5)) — none.

*Purposes of Changes and New Matter:*

1. This section seeks to protect and make effective all necessary and desirable modifications of sales contracts without regard to the technicalities which at present hamper such adjustments.

2. Subsection (1) (A.C.A. § 4-2-209(1)) provides that an agreement modifying a sales contract needs no consideration to be binding.

However, modifications made thereunder must meet the test of good faith imposed by this Act. The effective use of bad faith to escape performance on the original contract terms is barred, and the extortion of a "modification" without legitimate commercial reason is ineffective as a violation of the duty of good faith. Nor can a mere technical consideration support a modification made in bad faith.

The test of "good faith" between merchants or as against merchants includes "observance of reasonable commercial standards of fair dealing in the trade" (Section 2-103 (A.C.A. § 4-2-103)), and may in some situations require an objectively demonstrable reason for seeking a modification. But such matters as a market shift which makes performance come to involve a loss may provide such a reason even though there is no such unforeseen difficulty as would make out a legal excuse from performance under Sections 2-615 (A.C.A. § 4-2-615) and 2-616 (A.C.A. § 4-2-616).

3. Subsections (2) (A.C.A. § 4-2-209(2)) and (3) (A.C.A. § 4-2-209(3)) are intended to protect against false allegations of oral modifications. "Modification or rescission"

*Cross References:*

Point 1: Section 1-201 (A.C.A. § 4-1-201).

Point 2: Section 2-202 (A.C.A. § 4-2-202).

Point 3: Sections 2-209 (A.C.A. § 4-2-209), 2-601 (A.C.A. § 4-2-601) and 2-607 (A.C.A. § 4-2-607).

Point 4: Sections 2-605 (A.C.A. § 4-2-605) and 2-607 (A.C.A. § 4-2-607).

includes abandonment or other change by mutual consent, contrary to the decision in *Green v. Doniger*, 300 N.Y. 238, 90 N.E. 2d 56 (1949); it does not include unilateral "termination" or "cancellation" as defined in Section 2-106 (A.C.A. § 4-2-106).

The Statute of Frauds provisions of this Article (Chapter) are expressly applied to modifications by subsection (3) (A.C.A. § 4-2-209(3)). Under those provisions the "delivery and acceptance" test is limited to the goods which have been accepted, that is, to the past. "Modification" for the future cannot therefore be conjured up by oral testimony if the price involved is \$500.00 or more since such modification must be shown at least by an authenticated memo. And since a memo is limited in its effect to the quantity of goods set forth in it there is safeguard against oral evidence.

Subsection (2) (A.C.A. § 4-2-209(2)) permits the parties in effect to make their own Statute of Frauds as regards any future modification of the contract by giving effect to a clause in a signed agreement which expressly requires any modification to be by signed writing. But note that if a consumer is to be held to such a clause on a form supplied by a merchant it must be separately signed.

4. Subsection (4) (A.C.A. § 4-2-209(4)) is intended, despite the provision of subsections (2) (A.C.A. § 4-2-209(2)) and (3) (A.C.A. § 4-2-209(3)), to prevent contractual provisions excluding modification except by a signed writing from limiting in other respects the legal effect of the parties' actual later conduct. The effect of such conduct as a waiver is further regulated in subsection (5) (A.C.A. § 4-2-209(5)).

*Cross References:*

Point 1: Section 1-203 (A.C.A. § 4-1-203).



Point 2: Sections 1-201 (A.C.A. § 4-1-201), 1-203 (A.C.A. § 4-1-203), 2-615 (A.C.A. § 4-2-615) and 2-616 (A.C.A. § 4-2-616).

Point 3: Sections 2-106 (A.C.A. § 4-2-106), 2-201 (A.C.A. § 4-2-201) and 2-202 (A.C.A. § 4-2-202).

Point 4: Sections 2-202 (A.C.A. § 4-2-202) and 2-208 (A.C.A. § 4-2-208).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Between merchants". Section 2-104 (A.C.A. § 4-2-104).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-210 (A.C.A. § 4-2-210)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Generally, this section recognizes both delegation of performance and assignability as normal and permissible incidents of a contract for the sale of goods.

2. Delegation of performance, either in conjunction with an assignment or otherwise, is provided for by subsection (1) (A.C.A. § 4-2-210(1)) where no substantial reason can be shown as to why the delegated performance will not be as satisfactory as personal performance.

3. Under subsection (2) (A.C.A. § 4-2-210(2)) rights which are no longer executory such as a right to damages for breach or a right to payment of an "account" as defined in the Article (Chapter) on Secured Transactions (Article 9 (Chapter 9)) may be assigned although the agreement prohibits assignment. In such cases no question of delegation of any performance is involved. The assignment of a "contract right" as defined in the Article (Chapter) on Secured Transactions (Article 9 (Chapter 9)) is not covered by this subsection.

4. The nature of the contract or the circumstances of the case, however, may bar assignment of the contract even where delegation of performance is not involved. This Article (Chapter) and this section are intended to clarify this problem, particularly in cases dealing with output, requirement and exclusive dealing contracts. In the first place the section on requirements and exclusive dealing removes from the construction of the original contract most of the "personal discretion" element by substituting the reasonably objective standard of good faith operation of the plant or business to

be supplied. Secondly, the section on insecurity and assurances, which is specifically referred to in subsection (5) (A.C.A. § 4-2-210(5)) of this section, frees the other party from the doubts and uncertainty which may afflict him under an assignment of the character in question by permitting him to demand adequate assurance of due performance without which he may suspend his own performance. Subsection (5) (A.C.A. § 4-2-210(5)) is not in any way intended to limit the effect of the section on insecurity and assurances and the word "performance" includes the giving of orders under a requirements contract. Of course, in any case where a material personal discretion is sought to be transferred, effective assignment is barred by subsection (2) (A.C.A. § 4-2-210(2)).

5. Subsection (4) (A.C.A. § 4-2-210(4)) lays down a general rule of construction distinguishing between a normal commercial assignment, which substitutes the assignee for the assignor both as to rights and duties, and a financing assignment in which only the assignor's rights are transferred.

This Article (Chapter) takes no position on the possibility of extending some recognition or power to the original parties to work out normal commercial readjustments of the contract in the case of financing assignments even after the original obligor has been notified of the assignment. This question is dealt with in the Article (Chapter) on Secured Transactions (Article 9 (Chapter 9)).

6. Subsection (5) (A.C.A. § 4-2-210(5)) recognizes that the non-assigning original party has a stake in the reliability of the person with whom he has closed the orig-

inal contract, and is, therefore, entitled to due assurance that any delegated performance will be properly forthcoming.

7. This section is not intended as a complete statement of the law of delegation and assignment but is limited to clarifying a few points doubtful under the case law. Particularly, neither this section nor this Article (Chapter) touches directly on such questions as the need or effect of notice of the assignment, the rights of successive assignees, or any question of the form of an assignment, either as between the parties or as against any third parties. Some of these questions are dealt with in Article 9 (Chapter 9).

*Cross References:*

Point 3: Articles 5 and 9 (Chapters 5 and 9).

Point 4: Sections 2-306 (A.C.A. § 4-2-306) and 2-609 (A.C.A. § 4-2-609).

Point 5: Article 9 (Chapter 9), Sections 9-317 (A.C.A. § 4-9-317) and 9-318 (A.C.A. § 4-9-318).

Point 7: Article 9 (Chapter 9).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-301 (A.C.A. § 4-2-301)**

*Prior Uniform Statutory Provision:* Sections 11 and 41, Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:*

This section uses the term "obligation" in contrast to the term "duty" in order to provide for the "condition" aspects of delivery and payment insofar as they are not modified by other sections of this Article (Chapter) such as those on cure of tender. It thus replaces not only the general provisions of the Uniform Sales Act on the parties' duties, but also the general provisions of that Act on the effect of conditions. In order to determine what is "in accordance with the contract" under this Article (Chapter) usage of trade, course of dealing and performance, and the general background of circumstances must be given

due consideration in conjunction with the lay meaning of the words used to define the scope of the conditions and duties.

*Cross References:*

Section 1-106 (A.C.A. § 4-1-106). See also Sections 1-205 (A.C.A. § 4-1-205), 2-208 (A.C.A. § 4-2-208), 2-209 (A.C.A. § 4-2-209), 2-508 (A.C.A. § 4-2-508) and 2-612 (A.C.A. § 4-2-612).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-302 (A.C.A. § 4-2-302)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. This section is intended to make it possible for the courts to police explicitly against the contracts or clauses which they find to be unconscionable. In the past such policing has been accomplished by adverse construction of language, by manipulation of the rules of offer and accep-

tance or by determinations that the clause is contrary to public policy or to the dominant purpose of the contract. This section is intended to allow the court to pass directly on the unconscionability of the contract or particular clause therein and to make a conclusion of law as to its unconscionability. The basic test is whether, in the light of the general com-



mercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract. Subsection (2) (A.C.A. § 4-2-302(2)) makes it clear that it is proper for the court to hear evidence upon these questions. The principle is one of the prevention of oppression and unfair surprise (Cf. *Campbell Soup Co. v. Wentz*, 172 F.2d 80, 3d Cir. 1948) and not of disturbance of allocation of risks because of superior bargaining power. The underlying basis of this section is illustrated by the results in cases such as the following:

*Kansas City Wholesale Grocery Co. v. Weber Packing Corporation*, 93 Utah 414, 73 P.2d 1272 (1937), where a clause limiting time for complaints was held inapplicable to latent defects in a shipment of catsup which could be discovered only by microscopic analysis; *Hardy v. General Motors Acceptance Corporation*, 38 Ga.App. 463, 144 S.E. 327 (1928), holding that a disclaimer of warranty clause applied only to express warranties, thus letting in a fair implied warranty; *Andrews Bros. v. Singer & Co.* (1934 CA) 1 K.B. 17, holding that where a car with substantial mileage was delivered instead of a "new" car, a disclaimer of warranties, including those "implied," left unaffected an "express obligation" on the description, even though the Sale of Goods Act called such an implied warranty; *New Prague Flouring Mill Co. v. G. A. Spears*, 194 Iowa 417, 189 N.W. 815 (1922), holding that a clause permitting the seller, upon the buyer's failure to supply shipping instructions, to cancel, ship, or allow delivery date to be indefinitely postponed 30 days at a time by the inaction, does not indefinitely postpone the date of measuring damages for the buyer's breach, to the seller's advantage; and *Kansas Flour Mills Co. v. Dirks*, 100 Kan. 376, 164 P. 273 (1917), where under a similar clause in a rising market the court permitted the buyer to measure his damages for non-delivery at the end of only one 30 day

postponement; *Green v. Arcos, Ltd.* (1931 CA) 47 T.L.R. 336, where a blanket clause prohibiting rejection of shipments by the buyer was restricted to apply to shipments where discrepancies represented merely mercantile variations; *Meyer v. Packard Cleveland Motor Co.*, 106 Ohio St. 328, 140 N.E. 118 (1922), in which the court held that a "waiver" of all agreements not specified did not preclude implied warranty of fitness of a rebuilt dump truck for ordinary use as a dump truck; *Austin Co. v. J. H. Tillman Co.*, 104 Or. 541, 209 P. 131 (1922), where a clause limiting the buyer's remedy to return was held to be applicable only if the seller had delivered a machine needed for a construction job which reasonably met the contract description; *Bekkevold v. Potts*, 173 Minn. 87, 216 N.W. 790, 59 A.L.R. 1164 (1927), refusing to allow warranty of fitness for purpose imposed by law to be negated by clause excluding all warranties "made" by the seller; *Robert A. Munroe & Co. v. Meyer* (1930) 2 K.B. 312, holding that the warranty of description overrides a clause reading "with all faults and defects" where adulterated meat not up to the contract description was delivered.

2. Under this section the court, in its discretion, may refuse to enforce the contract as a whole if it is permeated by the unconscionability, or it may strike any single clause or group of clauses which are so tainted or which are contrary to the essential purpose of the agreement, or it may simply limit unconscionable clauses so as to avoid unconscionable results.

3. The present section is addressed to the court, and the decision is to be made by it. The commercial evidence referred to in subsection (2) (A.C.A. § 4-2-302(2)) is for the court's consideration, not the jury's. Only the agreement which results from the court's action on these matters is to be submitted to the general triers of the facts.

*Definitional Cross References:*

"Contract". Section 1-201 (A.C.A. § 4-1-201).



**Comment to § 2-303 (A.C.A. § 4-2-303)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. This section is intended to make it clear that the parties may modify or allocate “unless otherwise agreed” risks or burdens imposed by this Article (Chapter) as they desire, always subject, of course, to the provisions on unconscionability.

Compare Section 1-102(4) (A.C.A. § 4-1-102(4)).

2. The risk or burden may be divided by the express terms of the agreement or by the attending circumstances, since under the definition of “agreement” in this Act the circumstances surrounding the trans-

action as well as the express language used by the parties enter into the meaning and substance of the agreement.

*Cross References:*

Point 1: Sections 1-102 (A.C.A. § 4-1-102), 2-302 (A.C.A. § 4-2-302).

Point 2: Section 1-201 (A.C.A. § 4-1-201).

*Definitional Cross References:*

“Agreement”. Section 1-201 (A.C.A. § 4-1-201).

“Party”. Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-304 (A.C.A. § 4-2-304)**

*Prior Uniform Statutory Provision:* Subsections (2) and (3) of Section 9, Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:*

1. This section corrects the phrasing of the Uniform Sales Act so as to avoid misconstruction and produce greater accuracy in commercial result. While it continues the essential intent and purpose of the Uniform Sales Act it rejects any purely verbalistic construction in disregard of the underlying reason of the provisions.

2. Under subsection (1) (A.C.A. § 4-2-304(1)) the provisions of this Article (Chapter) are applicable to transactions where the “price” of goods is payable in something other than money. This does not mean, however, that this whole Article (Chapter) applies automatically and in its entirety simply because an agreed transfer of title to goods is not a gift. The basic purposes and reasons of the Article (Chapter) must always be considered in determining the applicability of any of its provisions.

3. Subsection (2) (A.C.A. § 4-2-304(2)) lays down the general principle that when goods are to be exchanged for realty, the provisions of this Article (Chapter) apply only to those aspects of the transaction which concern the transfer of title to goods but do not affect the transfer of the realty

since the detailed regulation of various particular contracts which fall outside the scope of this Article (Chapter) is left to the courts and other legislation. However, the complexities of these situations may be such that each must be analyzed in the light of the underlying reasons in order to determine the applicable principles. Local statutes dealing with realty are not to be lightly disregarded or altered by language of this Article (Chapter). In contrast, this Article (Chapter) declares definite policies in regard to certain matters legitimately within its scope though concerned with real property situations, and in those instances the provisions of this Article (Chapter) control.

*Cross References:*

Point 1: Section 1-102 (A.C.A. § 4-1-102).

Point 3: Sections 1-102 (A.C.A. § 4-1-102), 1-103 (A.C.A. § 4-1-103), 1-104 (A.C.A. § 4-1-104) and 2-107 (A.C.A. § 4-2-107).

*Definitional Cross References:*

“Goods”. Section 2-105 (A.C.A. § 4-2-105).

“Money”. Section 1-201 (A.C.A. § 4-1-201).

“Party”. Section 1-201 (A.C.A. § 4-1-201).

“Seller”. Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-305 (A.C.A. § 4-2-305)**

*Prior Uniform Statutory Provision:* Sections 9 and 10, Uniform Sales Act.

*Changes:* Completely rewritten.

*Purposes of Changes:*

1. This section applies when the price term is left open on the making of an agreement which is nevertheless intended by the parties to be a binding agreement. This Article (Chapter) rejects in these instances the formula that "an agreement to agree is unenforceable" if the case falls within subsection (1) (A.C.A. § 4-2-305(1)) of this section, and rejects also defeating such agreements on the ground of "indefiniteness". Instead this Article (Chapter) recognizes the dominant intention of the parties to have the deal continue to be binding upon both. As to future performance, since this Article (Chapter) recognizes remedies such as cover (Section 2-712 (A.C.A. § 4-2-712)), resale (Section 2-706 (A.C.A. § 4-2-706)) and specific performance (Section 2-716 (A.C.A. § 4-2-716)) which go beyond any mere arithmetic as between contract price and market price, there is usually a "reasonably certain basis for granting an appropriate remedy for breach" so that the contract need not fail for indefiniteness.

2. Under some circumstances the postponement of agreement on price will mean that no deal has really been concluded, and this is made express in the preamble of subsection (1) (A.C.A. § 4-2-305(1)) ("The parties if they so intend") and in subsection (4) (A.C.A. § 4-2-305(4)). Whether or not this is so is, in most cases, a question to be determined by the trier of fact.

3. Subsection (2) (A.C.A. § 4-2-305(2)), dealing with the situation where the price is to be fixed by one party rejects the uncommercial idea that an agreement that the seller may fix the price means that he may fix any price he may wish by the express qualification that the price so fixed must be fixed in good faith. Good faith includes observance of reasonable commercial standards of fair dealing in the trade if the party is a merchant. (Section 2-103 (A.C.A. § 4-2-103)). But in the normal case a "posted price" or a future seller's or buyer's "given price," "price in effect," "market price," or the like satisfies the good faith requirement.

4. The section recognizes that there may be cases in which a particular person's judgment is not chosen merely as a barometer or index of a fair price but is an essential condition to the parties' intent to make any contract at all. For example, the case where a known and trusted expert is to "value" a particular painting for which there is no market standard differs sharply from the situation where a named expert is to determine the grade of cotton, and the difference would support a finding that in the one the parties did not intend to make a binding agreement if that expert were unavailable whereas in the other they did so intend. Other circumstances would of course affect the validity of such a finding.

5. Under subsection (3) (A.C.A. § 4-2-305(3)), wrongful interference by one party with any agreed machinery for price fixing in the contract may be treated by the other party as a repudiation justifying cancellation, or merely as a failure to take cooperative action thus shifting to the aggrieved party the reasonable leeway in fixing the price.

6. Throughout the entire section, the purpose is to give effect to the agreement which has been made. That effect, however, is always conditioned by the requirement of good faith action which is made an inherent part of all contracts within this Act. (Section 1-203 (A.C.A. § 4-1-203)).

*Cross References:*

Point 1: Sections 2-204(3) (A.C.A. § 4-2-204(3)), 2-706 (A.C.A. § 4-2-706), 2-712 (A.C.A. § 4-2-712) and 2-716 (A.C.A. § 4-2-716).

Point 3: Section 2-103 (A.C.A. § 4-2-103).

Point 5: Sections 2-311 (A.C.A. § 4-2-311) and 2-610 (A.C.A. § 4-2-610).

Point 6: Section 1-203 (A.C.A. § 4-1-203).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Burden of establishing". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Cancellation". Section 2-106 (A.C.A. § 4-2-106).



"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Fault". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

### Comment to § 2-306 (A.C.A. § 4-2-306)

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-2-306(1)) of this section, in regard to output and requirements, applies to this specific problem the general approach of this Act which requires the reading of commercial background and intent into the language of any agreement and demands good faith in the performance of that agreement. It applies to such contracts of nonproducing establishments such as dealers or distributors as well as to manufacturing concerns.

2. Under this Article (Chapter), a contract for output or requirements is not too indefinite since it is held to mean the actual good faith output or requirements of the particular party. Nor does such a contract lack mutuality of obligation since, under this section, the party who will determine quantity is required to operate his plant or conduct his business in good faith and according to commercial standards of fair dealing in the trade so that his output or requirements will approximate a reasonably foreseeable figure. Reasonable elasticity in the requirements is expressly envisaged by this section and good faith variations from prior requirements are permitted even when the variation may be such as to result in discontinuance. A shut-down by a requirements buyer for lack of orders might be permissible when a shut-down merely to curtail losses would not. The essential test is whether the party is acting in good faith. Similarly, a sudden expansion of the plant by which requirements are to be measured would not be included within the scope of the contract as made but normal expansion undertaken in good faith would be within the scope of this section. One of the factors in an expansion situation would be whether the market price had risen greatly in a case in which the re-

quirements contract contained a fixed price. Reasonable variation of an extreme sort is exemplified in *Southwest Natural Gas Co. v. Oklahoma Portland Cement Co.*, 102 F.2d 630 (C.C.A. 10, 1939). This Article (Chapter) takes no position as to whether a requirements contract is a provable claim in bankruptcy.

3. If an estimate of output or requirements is included in the agreement, no quantity unreasonably disproportionate to it may be tendered or demanded. Any minimum or maximum set by the agreement shows a clear limit on the intended elasticity. In similar fashion, the agreed estimate is to be regarded as a center around which the parties intend the variation to occur.

4. When an enterprise is sold, the question may arise whether the buyer is bound by an existing output or requirements contract. That question is outside the scope of this Article (Chapter), and is to be determined on other principles of law. Assuming that the contract continues, the output or requirements in the hands of the new owner continue to be measured by the actual good faith output or requirements under the normal operation of the enterprise prior to sale. The sale itself is not grounds for sudden expansion or decrease.

5. Subsection (2) (A.C.A. § 4-2-306(2)), on exclusive dealing, makes explicit the commercial rule embodied in this Act under which the parties to such contracts are held to have impliedly, even when not expressly, bound themselves to use reasonable diligence as well as good faith in their performance of the contract. Under such contracts the exclusive agent is required, although no express commitment has been made, to use reasonable effort and due diligence in the expansion of the market or the promotion of the product, as the case may be. The principal is expected



under such a contract to refrain from supplying any other dealer or agent within the exclusive territory. An exclusive dealing agreement brings into play all of the good faith aspects of the output and requirement problems of subsection (1) (A.C.A. § 4-2-306(1)). It also raises questions of insecurity and right to adequate assurance under this Article (Chapter).

*Cross References:*

Point 4: Section 2-210 (A.C.A. § 4-2-210).

Point 5: Sections 1-203 (A.C.A. § 4-1-203) and 2-609 (A.C.A. § 4-2-609).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-307 (A.C.A. § 4-2-307)**

*Prior Uniform Statutory Provision:* Section 45(1), Uniform Sales Act.

*Changes:* Rewritten and expanded.

*Purposes of Changes:*

1. This section applies where the parties have not specifically agreed whether delivery and payment are to be by lots and generally continues the essential intent of original Act, Section 45(1) by assuming that the parties intended delivery to be in a single lot.

2. Where the actual agreement or the circumstances do not indicate otherwise, delivery in lots is not permitted under this section and the buyer is properly entitled to reject for a deficiency in the tender, subject to any privilege in the seller to cure the tender.

3. The "but" clause of this section goes to the case in which it is not commercially feasible to deliver or to receive the goods in a single lot as for example, where a contract calls for the shipment of ten carloads of coal and only three cars are available at a given time. Similarly, in a contract involving brick necessary to build a building the buyer's storage space may be limited so that it would be impossible to receive the entire amount of brick at once, or it may be necessary to assemble the goods as in the case of cattle on the range, or to mine them.

In such cases, a partial delivery is not subject to rejection for the defect in quan-

tity alone, if the circumstances do not indicate a repudiation or default by the seller as to the expected balance or do not give the buyer ground for suspending his performance because of insecurity under the provisions of Section 2-609 (A.C.A. § 4-2-609). However, in such cases the undelivered balance of goods under the contract must be forthcoming within a reasonable time and in a reasonable manner according to the policy of Section 2-503 (A.C.A. § 4-2-503) on manner of tender of delivery. This is reinforced by the express provisions of Section 2-608 (A.C.A. § 4-2-608) that if a lot has been accepted on the reasonable assumption that its nonconformity will be cured, the acceptance may be revoked if the cure does not seasonably occur. The section rejects the rule of *Kelly Construction Co. v. Hackensack Brick Co.*, 91 N.J.L. 585, 103 A. 417, 2 A.L.R. 685 (1918) and approves the result in *Lynn M. Ranger, Inc. v. Gildersleeve*, 106 Conn. 372, 138 A. 142 (1927) in which a contract was made for six carloads of coal then rolling from the mines and consigned to the seller but the seller agreed to divert the carloads to the buyer as soon as the car numbers became known to him. He arranged a diversion of two cars and then notified the buyer who then repudiated the contract. The seller was held to be entitled to his full remedy for the two cars diverted because simultaneous delivery of all of the cars was not contemplated by either party.

4. Where the circumstances indicate that a party has a right to delivery in lots, the price may be demanded for each lot if it is apportionable.

*Cross References:*

Point 1: Section 1-201 (A.C.A. § 4-1-201).

Point 2: Sections 2-508 (A.C.A. § 4-2-508) and 2-601 (A.C.A. § 4-2-601).

Point 3: Sections 2-503 (A.C.A. § 4-2-503), 2-608 (A.C.A. § 4-2-608) and 2-609 (A.C.A. § 4-2-609).

*Definitional Cross References:*

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Lot". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-308 (A.C.A. § 4-2-308)**

*Prior Uniform Statutory Provision:* Paragraphs (a) (A.C.A. § 4-2-308(a)) and (b) (A.C.A. § 4-2-308(b)) — Section 43(1), Uniform Sales Act; Paragraph (c) (A.C.A. § 4-2-308(c)) — none.

*Changes:* Slight modification in language.

*Purposes of Changes and New Matter:*

1. Paragraphs (a) (A.C.A. § 4-2-308(a)) and (b) (A.C.A. § 4-2-308(b)) provide for those noncommercial sales and for those occasional commercial sales where no place or means of delivery has been agreed upon by the parties. Where delivery by carrier is "required or authorized by the agreement," the seller's duties as to delivery of the goods are governed not by this section but by Section 2-504 (A.C.A. § 4-2-504).

2. Under paragraph (b) (A.C.A. § 4-2-308(b)) when the identified goods contracted for are known to both parties to be in some location other than the seller's place of business or residence, the parties are presumed to have intended that place to be the place of delivery. This paragraph also applies (unless, as would be normal, the circumstances show that delivery by way of documents is intended) to a bulk of goods in the possession of a bailee. In such a case, however, the seller has the additional obligation to procure the acknowledgment by the bailee of the buyer's right to possession.

3. Where "customary banking channels" call only for due notification by the banker that the documents are on hand, leaving the buyer himself to see to the physical receipt of the goods, tender at the buyer's address is not required under paragraph (c) (A.C.A. § 4-2-308(c)). But

that paragraph merely eliminates the possibility of a default by the seller if "customary banking channels" have been properly used in giving notice to the buyer. Where the bank has purchased a draft accompanied by documents or has undertaken its collection on behalf of the seller, Part 5 of Article 4 (Chapter 4) spells out its duties and relations to its customer. Where the documents move forward under a letter of credit the Article (Chapter) on Letters of Credit spells out the duties and relations between the bank, the seller and the buyer.

4. The rules of this section apply only "unless otherwise agreed." The surrounding circumstances, usage of trade, course of dealing and course of performance, as well as the express language of the parties, may constitute an "otherwise agreement."

*Cross References:*

Point 1: Sections 2-504 (A.C.A. § 4-2-504) and 2-505 (A.C.A. § 4-2-505).

Point 2: Section 2-503 (A.C.A. § 4-2-503).

Point 3: Section 2-512 (A.C.A. § 4-2-512), Articles 4 (Chapter 4), Part 5, and 5 (Chapter 5).

*Definitional Cross References:*

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).



**Comment to § 2-309 (A.C.A. § 4-2-309)**

*Prior Uniform Statutory Provision:* Subsection (1) (A.C.A. § 4-2-309(1)) — see Sections 43(2), 45(2), 47(1) and 48, Uniform Sales Act, for policy continued under this Article; Subsection (2) (A.C.A. § 4-2-309(2)) — none; Subsection (3) (A.C.A. § 4-2-309(3)) — none.

*Changes:* Completely different in scope.

*Purposes of Changes and New Matter:*

1. Subsection (1) (A.C.A. § 4-2-309(1)) requires that all actions taken under a sales contract must be taken within a reasonable time where no time has been agreed upon. The reasonable time under this provision turns on the criteria as to “reasonable time” and on good faith and commercial standards set forth in Sections 1-203 (A.C.A. § 4-1-203), 1-204 (A.C.A. § 4-1-204) and 2-103 (A.C.A. § 4-2-103). It thus depends upon what constitutes acceptable commercial conduct in view of the nature, purpose and circumstances of the action to be taken. Agreement as to a definite time, however, may be found in a term implied from the contractual circumstances, usage of trade or course of dealing or performance as well as in an express term. Such cases fall outside of this subsection since in them the time for action is “agreed” by usage.

2. The time for payment, where not agreed upon, is related to the time for delivery; the particular problems which arise in connection with determining the appropriate time of payment and the time for any inspection before payment which is both allowed by law and demanded by the buyer are covered in Section 2-513 (A.C.A. § 4-2-513).

3. The facts in regard to shipment and delivery differ so widely as to make detailed provision for them in the text of this Article (Chapter) impracticable. The applicable principles, however, make it clear that surprise is to be avoided, good faith judgment is to be protected, and notice or negotiation to reduce the uncertainty to certainty is to be favored.

4. When the time for delivery is left open, unreasonably early offers of or demands for delivery are intended to be read under this Article (Chapter) as expressions of desire or intention, requesting the assent or acquiescence of the other party,

not as final positions which may amount without more to breach or to create breach by the other side. See Sections 2-207 (A.C.A. § 4-2-207) and 2-609 (A.C.A. § 4-2-609).

5. The obligation of good faith under this Act requires reasonable notification before a contract may be treated as breached because a reasonable time for delivery or demand has expired. This operates both in the case of a contract originally indefinite as to time and of one subsequently made indefinite by waiver.

When both parties let an originally reasonable time go by in silence the course of conduct under the contract may be viewed as enlarging the reasonable time for tender or demand of performance. The contract may be terminated by abandonment.

6. Parties to a contract are not required in giving reasonable notification to fix, at peril of breach, a time which is in fact reasonable in the unforeseeable judgment of a later trier of fact. Effective communication of a proposed time limit calls for a response, so that failure to reply will make out acquiescence. Where objection is made, however, or if the demand is merely for information as to when goods will be delivered or will be ordered out, demand for assurances on the ground of insecurity may be made under this Article (Chapter) pending further negotiations. Only when a party insists on undue delay or on rejection of the other party’s reasonable proposal is there a question of flat breach under the present section.

7. Subsection (2) (A.C.A. § 4-2-309(2)) applies a commercially reasonable view to resolve the conflict which has arisen in the cases as to contracts of indefinite duration. The “reasonable time” of duration appropriate to a given arrangement is limited by the circumstances. When the arrangement has been carried on by the parties over the years, the “reasonable time” can continue indefinitely and the contract will not terminate until notice.

8. Subsection (3) (A.C.A. § 4-2-309(3)) recognizes that the application of principles of good faith and sound commercial practice normally call for such notification of the termination of a going contract relationship as will give the other party reasonable time to seek a substitute ar-



rangement. An agreement dispensing with notification or limiting the time for the seeking of a substitute arrangement is, of course, valid under this subsection unless the results of putting it into operation would be the creation of an unconscionable state of affairs.

9. Justifiable cancellation for breach is a remedy for breach and is not the kind of termination covered by the present subsection.

10. The requirement of notification is dispensed with where the contract provides for termination on the happening of an "agreed event." "Event" is a term chosen here to contrast with "option" or the like.

#### *Cross References:*

Point 1: Sections 1-203 (A.C.A. § 4-1-203), 1-204 (A.C.A. § 4-1-204) and 2-103 (A.C.A. § 4-2-103).

Point 2: Sections 2-320 (A.C.A. § 4-2-320), 2-321 (A.C.A. § 4-2-321), 2-504 (A.C.A. § 4-2-504), and 2-511 through 2-514 (A.C.A. §§ 4-2-511 through 4-2-514).

Point 5: Section 1-203 (A.C.A. § 4-1-203).

Point 6: Section 2-609 (A.C.A. § 4-2-609).

Point 7: Section 2-204 (A.C.A. § 4-2-204).

Point 9: Sections 2-106 (A.C.A. § 4-2-106), 2-318 (A.C.A. § 4-2-318), 2-610 (A.C.A. § 4-2-610) and 2-703 (A.C.A. § 4-2-703).

#### *Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Termination". Section 2-106 (A.C.A. § 4-2-106).

### **Comment to § 2-310 (A.C.A. § 4-2-310)**

*Prior Uniform Statutory Provision:* Sections 42 and 47(2), Uniform Sales Act.

*Changes:* Completely rewritten in this and other sections.

*Purposes of Changes:* This section is drawn to reflect modern business methods of dealing at a distance rather than face to face. Thus:

1. Paragraph (a) (A.C.A. § 4-2-310(a)) provides that payment is due at the time and place "the buyer is to receive the goods" rather than at the point of delivery except in documentary shipment cases (paragraph (c) (A.C.A. § 4-2-310(c))). This grants an opportunity for the exercise by the buyer of his preliminary right to inspection before paying even though under the delivery term the risk of loss may have previously passed to him or the running of the credit period has already started.

2. Paragraph (b) (A.C.A. § 4-2-310(b)) while providing for inspection by the buyer before he pays, protects the seller. He is not required to give up possession of the goods until he has received payment, where no credit has been contemplated by the parties. The seller may collect through

a bank by a sight draft against an order bill of lading "hold until arrival; inspection allowed." The obligations of the bank under such a provision are set forth in Part 5 of Article 4 (Chapter 4). In the absence of a credit term, the seller is permitted to ship under reservation and if he does payment is then due where and when the buyer is to receive the documents.

3. Unless otherwise agreed, the place for the receipt of the documents and payment is the buyer's city but the time for payment is only after arrival of the goods, since under paragraph (b) (A.C.A. § 4-2-310(b)), and Sections 2-512 (A.C.A. § 4-2-512) and 2-513 (A.C.A. § 4-2-513) the buyer is under no duty to pay prior to inspection.

4. Where the mode of shipment is such that goods must be unloaded immediately upon arrival, too rapidly to permit adequate inspection before receipt, the seller must be guided by the provisions of this Article (Chapter) on inspection which provide that if the seller wishes to demand payment before inspection, he must put an appropriate term into the contract.

Even requiring payment against documents will not of itself have this desired result if the documents are to be held until the arrival of the goods. But under (b) (A.C.A. § 4-2-310(b)) and (c) (A.C.A. § 4-2-310(c)) if the terms are C.I.F., C.O.D., or cash against documents payment may be due before inspection.

5. Paragraph (d) (A.C.A. § 4-2-310(d)) states the common commercial understanding that an agreed credit period runs from the time of shipment or from that dating of the invoice which is commonly recognized as a representation of the time of shipment. The provision concerning any delay in sending forth the invoice is included because such conduct results in depriving the buyer of his full notice and warning as to when he must be prepared to pay.

*Cross References:*

Generally: Part 5.

Point 1: Section 2-509 (A.C.A. § 4-2-509).

Point 2: Sections 2-505 (A.C.A. § 4-2-

505), 2-511 (A.C.A. § 4-2-511), 2-512 (A.C.A. § 4-2-512), 2-513 (A.C.A. § 4-2-513) and Article 4 (Chapter 4).

Point 3: Sections 2-308(b) (A.C.A. § 4-2-308(b)), 2-512 (A.C.A. § 4-2-512) and 2-513 (A.C.A. § 4-2-513).

Point 4: Section 2-513(3)(b) (A.C.A. § 4-2-513(3)(b)).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-311 (A.C.A. § 4-2-311)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-2-311(1)) permits the parties to leave certain detailed particulars of performance to be filled in by either of them without running the risk of having the contract invalidated for indefiniteness. The party to whom the agreement gives power to specify the missing details is required to exercise good faith and to act in accordance with commercial standards so that there is no surprise and the range of permissible variation is limited by what is commercially reasonable. The "agreement" which permits one party so to specify may be found as well in a course of dealing, usage of trade, or implication from circumstances as in explicit language used by the parties.

2. Options as to assortment of goods or shipping arrangements are specifically reserved to the buyer and seller respectively under subsection (2) (A.C.A. § 4-2-311(2)) where no other arrangement has been made. This section rejects the test which mechanically and without regard to usage or the purpose of the option gave the

option to the party "first under a duty to move" and applies instead a standard commercial interpretation to these circumstances. The "unless otherwise agreed" provision of this subsection covers not only express terms but the background and circumstances which enter into the agreement.

3. Subsection (3) (A.C.A. § 4-2-311(3)) applies when the exercise of an option or cooperation by one party is necessary to or materially affects the other party's performance, but it is not seasonably forthcoming; the subsection relieves the other party from the necessity for performance or excuses his delay in performance as the case may be. The contract-keeping party may at his option under this subsection proceed to perform in any commercially reasonable manner rather than wait. In addition to the special remedies provided, this subsection also reserves "all other remedies". The remedy of particular importance in this connection is that provided for insecurity. Requests may also be made pursuant to the obligation of good faith for a reasonable indication of the time and manner of performance for which a party is to hold himself ready.



4. The remedy provided in subsection (3) (A.C.A. § 4-2-311(3)) is one which does not operate in the situation which falls within the scope of Section 2-614 (A.C.A. § 4-2-614) on substituted performance. Where the failure to cooperate results from circumstances set forth in that Section, the other party is under a duty to proffer or demand (as the case may be) substitute performance as a condition to claiming rights against the noncooperating party.

*Cross References:*

Point 1: Sections 1-201 (A.C.A. § 4-1-201), 1-203 (A.C.A. § 4-1-203) and 1-204 (A.C.A. § 4-1-204).

Point 3: Sections 1-203 (A.C.A. § 4-1-203) and 2-609 (A.C.A. § 4-2-609).

Point 4: Section 2-614 (A.C.A. § 4-2-614).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-312 (A.C.A. § 4-2-312)**

*Prior Uniform Statutory Provision:* Section 13, Uniform Sales Act.

*Changes:* Completely rewritten, the provisions concerning infringement being new.

*Purposes of Changes:*

1. Subsection (1) (A.C.A. § 4-2-312(1)) makes provision for a buyer's basic needs in respect to a title which he in good faith expects to acquire by his purchase, namely, that he receive a good, clean title transferred to him also in a rightful manner so that he will not be exposed to a lawsuit in order to protect it.

The warranty extends to a buyer whether or not the seller was in possession of the goods at the time the sale or contract to sell was made.

The warranty of quiet possession is abolished. Disturbance of quiet possession, although not mentioned specifically, is one way, among many, in which the breach of the warranty of title may be established.

The "knowledge" referred to in subsection 1(b) (A.C.A. § 4-2-312(1)(b)) is actual knowledge as distinct from notice.

2. The provisions of this Article (Chapter) requiring notification to the seller within a reasonable time after the buyer's discovery of a breach apply to notice of a breach of the warranty of title, where the seller's breach was innocent. However, if

the seller's breach was in bad faith he cannot be permitted to claim that he has been misled or prejudiced by the delay in giving notice. In such case the "reasonable" time for notice should receive a very liberal interpretation. Whether the breach by the seller is in good or bad faith Section 2-725 (A.C.A. § 4-2-725) provides that the cause of action accrues when the breach occurs. Under the provisions of that section the breach of the warranty of good title occurs when tender of delivery is made since the warranty is not one which extends to "future performance of the goods."

3. When the goods are part of the seller's normal stock and are sold in his normal course of business, it is his duty to see that no claim of infringement of a patent or trademark by a third party will mar the buyer's title. A sale by a person other than a dealer, however, raises no implication in its circumstances of such a warranty. Nor is there such an implication when the buyer orders goods to be assembled, prepared or manufactured on his own specifications. If, in such a case, the resulting product infringes a patent or trademark, the liability will run from buyer to seller. There is, under such circumstances, a tacit representation on the part of the buyer that the seller will be safe in manufacturing according to the



specifications, and the buyer is under an obligation in good faith to indemnify him for any loss suffered.

4. This section rejects the cases which recognize the principle that infringements violate the warranty of title but deny the buyer a remedy unless he has been expressly prevented from using the goods. Under this Article (Chapter) "eviction" is not a necessary condition to the buyer's remedy since the buyer's remedy arises immediately upon receipt of notice of infringement; it is merely one way of establishing the fact of breach.

5. Subsection (2) (A.C.A. § 4-2-312(2)) recognizes that sales by sheriffs, executors, foreclosing lienors and persons similarly situated are so out of the ordinary commercial course that their peculiar character is immediately apparent to the buyer and therefore no personal obligation is imposed upon the seller who is purporting to sell only an unknown or limited right. This subsection does not touch upon and leaves open all questions of restitution arising in such cases, when a unique article so sold is reclaimed by a third party as the rightful owner.

6. The warranty of subsection (1) (A.C.A. § 4-2-312(1)) is not designated as an "implied" warranty, and hence is not

subject to Section 2-316(3) (A.C.A. § 4-2-316(3)). Disclaimer of the warranty of title is governed instead by subsection (2) (A.C.A. § 4-2-312(2)), which requires either specific language or the described circumstances.

*Cross References:*

Point 1: Section 2-403 (A.C.A. § 4-2-403).

Point 2: Sections 2-607 (A.C.A. § 4-2-607) and 2-725 (A.C.A. § 4-2-725).

Point 3: Section 1-203 (A.C.A. § 4-1-203).

Point 4: Sections 2-609 (A.C.A. § 4-2-609) and 2-725 (A.C.A. § 4-2-725).

Point 6: Section 2-316 (A.C.A. § 4-2-316).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-313 (A.C.A. § 4-2-313)**

*Prior Uniform Statutory Provision:* Sections 12, 14 and 16, Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:* To consolidate and systematize basic principles with the result that:

1. "Express" warranties rest on "dickered" aspects of the individual bargain, and go so clearly to the essence of that bargain that words of disclaimer in a form are repugnant to the basic dickered terms. "Implied" warranties rest so clearly on a common factual situation or set of conditions that no particular language or action is necessary to evidence them and they will arise in such a situation unless unmistakably negated.

This section reverts to the older case law insofar as the warranties of description and sample are designated "express" rather than "implied".

2. Although this section is limited in its

scope and direct purpose to warranties made by the seller to the buyer as part of a contract for sale, the warranty sections of this Article (Chapter) are not designed in any way to disturb those lines of case law growth which have recognized that warranties need not be confined either to sales contracts or to the direct parties to such a contract. They may arise in other appropriate circumstances such as in the case of bailments for hire, whether such bailment is itself the main contract or is merely a supplying of containers under a contract for the sale of their contents. The provisions of Section 2-318 (A.C.A. § 4-2-318) on third party beneficiaries expressly recognize this case law development within one particular area. Beyond that, the matter is left to the case law with the intention that the policies of this Act may offer useful guidance in dealing with further cases as they arise.

3. The present section deals with affirmations of fact by the seller, descrip-

tions of the goods or exhibitions of samples, exactly as any other part of a negotiation which ends in a contract is dealt with. No specific intention to make a warranty is necessary if any of these factors is made part of the basis of the bargain. In actual practice affirmations of fact made by the seller about the goods during a bargain are regarded as part of the description of those goods; hence no particular reliance on such statements need be shown in order to weave them into the fabric of the agreement. Rather, any fact which is to take such affirmations, once made, out of the agreement requires clear affirmative proof. The issue normally is one of fact.

4. In view of the principle that the whole purpose of the law of warranty is to determine what it is that the seller has in essence agreed to sell, the policy is adopted of those cases which refuse except in unusual circumstances to recognize a material deletion of the seller's obligation. Thus, a contract is normally a contract for a sale of something describable and described. A clause generally disclaiming "all warranties, express or implied" cannot reduce the seller's obligation with respect to such description and therefore cannot be given literal effect under Section 2-316 (A.C.A. § 4-2-316).

This is not intended to mean that the parties, if they consciously desire, cannot make their own bargain as they wish. But in determining what they have agreed upon good faith is a factor and consideration should be given to the fact that the probability is small that a real price is intended to be exchanged for a pseudo-obligation.

5. Paragraph (1)(b) (A.C.A. § 4-2-313(1)(b)) makes specific some of the principles set forth above when a description of the goods is given by the seller.

A description need not be by words. Technical specifications, blueprints and the like can afford more exact description than mere language and if made part of the basis of the bargain goods must conform with them. Past deliveries may set the description of quality, either expressly or impliedly by course of dealing. Of course, all descriptions by merchants must be read against the applicable trade usages with the general rules as to merchantability resolving any doubts.

6. The basic situation as to statements

affecting the true essence of the bargain is no different when a sample or model is involved in the transaction. This section includes both a "sample" actually drawn from the bulk of goods which is the subject matter of the sale, and a "model" which is offered for inspection when the subject matter is not at hand and which has not been drawn from the bulk of the goods.

Although the underlying principles are unchanged, the facts are often ambiguous when something is shown as illustrative, rather than as a straight sample. In general, the presumption is that any sample or model just as any affirmation of fact is intended to become a basis of the bargain. But there is no escape from the question of fact. When the seller exhibits a sample purporting to be drawn from an existing bulk, good faith of course requires that the sample be fairly drawn. But in mercantile experience the mere exhibition of a "sample" does not of itself show whether it is merely intended to "suggest" or to "be" the character of the subject-matter of the contract. The question is whether the seller has so acted with reference to the sample as to make him responsible that the whole shall have at least the values shown by it. The circumstances aid in answering this question. If the sample has been drawn from an existing bulk, it must be regarded as describing values of the goods contracted for unless it is accompanied by an unmistakable denial of such responsibility. If, on the other hand, a model of merchandise not on hand is offered, the mercantile presumption that it has become a literal description of the subject matter is not so strong, and particularly so if modification on the buyer's initiative impairs any feature of the model.

7. The precise time when words of description or affirmation are made or samples are shown is not material. The sole question is whether the language or samples or models are fairly to be regarded as part of the contract. If language is used after the closing of the deal (as when the buyer when taking delivery asks and receives an additional assurance), the warranty becomes a modification, and need not be supported by consideration if it is otherwise reasonable and in order (Section 2-209 (A.C.A. § 4-2-209)).

8. Concerning affirmations of value or a seller's opinion or commendation under subsection (2) (A.C.A. § 4-2-313(2)), the



basic question remains the same: What statements of the seller have in the circumstances and in objective judgment become part of the basis of the bargain? As indicated above, all of the statements of the seller do so unless good reason is shown to the contrary. The provisions of subsection (2) are included, however, since common experience discloses that some statements or predictions cannot fairly be viewed as entering into the bargain. Even as to false statements of value, however, the possibility is left open that a remedy may be provided by the law relating to fraud or misrepresentation.

*Cross References:*

Point 1: Section 2-316 (A.C.A. § 4-2-316).

Point 2: Sections 1-102(3) (A.C.A. § 4-1-102(3)) and 2-318 (A.C.A. § 4-2-318).

Point 3: Section 2-316(2)(b) (A.C.A. § 4-2-316(2)(b))\*.

Point 4: Section 2-316 (A.C.A. § 4-2-316).

Point 5: Sections 1-205(4) (A.C.A. § 4-1-205(4)) and 2-314 (A.C.A. § 4-2-314).

Point 6: Section 2-316 (A.C.A. § 4-2-316).

Point 7: Section 2-209 (A.C.A. § 4-2-209).

Point 8: Section 1-103 (A.C.A. § 4-1-103).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conforming". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

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\*This appears to be an incorrect reference since there is no (2)(b) in § 4-2-316.

**Comment to § 2-314 (A.C.A. § 4-2-314)**

*Prior Uniform Statutory Provision:* Section 15(2), Uniform Sales Act.

*Changes:* Completely rewritten.

*Purposes of Changes:* This section, drawn in view of the steadily developing case law on the subject, is intended to make it clear that:

1. The seller's obligation applies to present sales as well as to contracts to sell subject to the effects of any examination of specific goods. (Subsection (2) of Section 2-316 (A.C.A. § 4-2-316)). Also, the warranty of merchantability applies to sales for use as well as to sales for resale.

2. The question when the warranty is imposed turns basically on the meaning of the terms of the agreement as recognized in the trade. Goods delivered under an agreement made by a merchant in a given line of trade must be of a quality comparable to that generally acceptable in that line of trade under the description or other designation of the goods used in the agreement. The responsibility imposed rests on any merchant-seller, and the absence of the words "grower or manufacturer or not" which appeared in Section 15(2) of the Uniform Sales Act does not restrict the applicability of this section.

3. A specific designation of goods by the buyer does not exclude the seller's obligation that they be fit for the general purposes appropriate to such goods. A contract for the sale of second-hand goods, however, involves only such obligation as is appropriate to such goods for that is their contract description. A person making an isolated sale of goods is not a "merchant" within the meaning of the full scope of this section and, thus, no warranty of merchantability would apply. His knowledge of any defects not apparent on inspection would, however, without need for express agreement and in keeping with the underlying reason of the present section and the provisions on good faith, impose an obligation that known material but hidden defects be fully disclosed.

4. Although a seller may not be a "merchant" as to the goods in question, if he states generally that they are "guaranteed" the provisions of this section may furnish a guide to the content of the resulting express warranty. This has particular significance in the case of second-hand sales, and has further significance in limiting the effect of fine-print disclaimer clauses where their effect would be incon-



sistent with large-print assertions of "guarantee".

5. The second sentence of subsection (1) (A.C.A. § 4-2-314(1)) covers the warranty with respect to food and drink. Serving food or drink for value is a sale, whether to be consumed on the premises or elsewhere. Cases to the contrary are rejected. The principal warranty is that stated in subsections (1) and (2)(c) (A.C.A. § 4-2-314(1) and (2)(c)) of this section.

6. Subsection (2) (A.C.A. § 4-2-314(2)) does not purport to exhaust the meaning of "merchantable" nor to negate any of its attributes not specifically mentioned in the text of the statute, but arising by usage of trade or through case law. The language used is "must be at least such as..." and the intention is to leave open other possible attributes of merchantability.

7. Paragraphs (a) and (b) of subsection (2) (A.C.A. § 4-2-314(2)(a) and (b)) are to be read together. Both refer, as indicated above, to the standards of that line of the trade which fits the transaction and the seller's business. "Fair average" is a term directly appropriate to agricultural bulk products and means goods centering around the middle belt of quality, not the least or the worst that can be understood in the particular trade by the designation, but such as can pass "without objection." Of course a fair percentage of the least is permissible but the goods are not "fair average" if they are all of the least or worst quality possible under the description. In cases of doubt as to what quality is intended, the price at which a merchant closes a contract is an excellent index of the nature and scope of his obligation under the present section.

8. Fitness for the ordinary purposes for which goods of the type are used is a fundamental concept of the present section and is covered in paragraph (c) (A.C.A. § 4-2-314(2)(c)). As stated above, merchantability is also a part of the obligation owing to the purchaser for use. Correspondingly, protection, under this aspect of the warranty, of the person buying for resale to the ultimate consumer is equally necessary, and merchantable goods must therefore be "honestly" resalable in the normal course of business because they are what they purport to be.

9. Paragraph (d) (A.C.A. § 4-2-314(2)(d)) on evenness of kind, quality and

quantity follows case law. But precautionary language has been added as a reminder of the frequent usages of trade which permit substantial variations both with and without an allowance or an obligation to replace the varying units.

10. Paragraph (e) (A.C.A. § 4-2-314(2)(e)) applies only where the nature of the goods and of the transaction require a certain type of container, package or label. Paragraph (f) (A.C.A. § 4-2-314(2)(f)) applies, on the other hand, wherever there is a label or container on which representations are made, even though the original contract, either by express terms or usage of trade, may not have required either the labelling or the representation. This follows from the general obligation of good faith which requires that a buyer should not be placed in the position of reselling or using goods delivered under false representations appearing on the package or container. No problem of extra consideration arises in this connection since, under this Article, an obligation is imposed by the original contract not to deliver mislabeled articles, and the obligation is imposed where mercantile good faith so requires and without reference to the doctrine of consideration.

11. Exclusion or modification of the warranty of merchantability, or of any part of it, is dealt with in the section to which the text of the present section makes explicit precautionary references. That section must be read with particular reference to its subsection (4) (A.C.A. § 4-2-316(4)) on limitation of remedies. The warranty of merchantability, wherever it is normal, is so commonly taken for granted that its exclusion from the contract is a matter threatening surprise and therefore requiring special precaution.

12. Subsection (3) (A.C.A. § 4-2-314(3)) is to make explicit that usage of trade and course of dealing can create warranties and that they are implied rather than express warranties and thus subject to exclusion or modification under Section 2-316 (A.C.A. § 4-2-316). A typical instance would be the obligation to provide pedigree papers to evidence conformity of the animal to the contract in the case of a pedigreed dog or blooded bull.

13. In an action based on breach of warranty, it is of course necessary to show not only the existence of the warranty but the fact that the warranty was broken and

that the breach of the warranty was the proximate cause of the loss sustained. In such an action an affirmative showing by the seller that the loss resulted from some action or event following his own delivery of the goods can operate as a defense. Equally, evidence indicating that the seller exercised care in the manufacture, processing or selection of the goods is relevant to the issue of whether the warranty was in fact broken. Action by the buyer following an examination of the goods which ought to have indicated the defect complained of can be shown as matter bearing on whether the breach itself was the cause of the injury.

*Cross References:*

Point 1: Section 2-316 (A.C.A. § 4-2-316).

Point 3: Sections 1-203 (A.C.A. § 4-1-203) and 2-104 (A.C.A. § 4-2-104).

Point 5: Section 2-315 (A.C.A. § 4-2-315).

Point 11: Section 2-316 (A.C.A. § 4-2-316).

Point 12: Sections 1-201 (A.C.A. § 4-1-201), 1-205 (A.C.A. § 4-1-205) and 2-316 (A.C.A. § 4-2-316).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Merchant". Section 2-104 (A.C.A. § 4-2-104).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-315 (A.C.A. § 4-2-315)**

*Prior Uniform Statutory Provision:* Section 15 (1), (4), (5), Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:*

1. Whether or not this warranty arises in any individual case is basically a question of fact to be determined by the circumstances of the contracting. Under this section the buyer need not bring home to the seller actual knowledge of the particular purpose for which the goods are intended or of his reliance on the seller's skill and judgment, if the circumstances are such that the seller has reason to realize the purpose intended or that the reliance exists. The buyer, of course, must actually be relying on the seller.

2. A "particular purpose" differs from the ordinary purpose for which the goods are used in that it envisages a specific use by the buyer which is peculiar to the nature of his business whereas the ordinary purposes for which goods are used are those envisaged in the concept of merchantability and go to uses which are customarily made of the goods in question. For example, shoes are generally used for the purpose of walking upon ordinary ground, but a seller may know that a particular pair was selected to be used for climbing mountains.

A contract may of course include both a

warranty of merchantability and one of fitness for a particular purpose.

The provisions of this Article (Chapter) on the cumulation and conflict of express and implied warranties must be considered on the question of inconsistency between or among warranties. In such a case any question of fact as to which warranty was intended by the parties to apply must be resolved in favor of the warranty of fitness for particular purpose as against all other warranties except where the buyer has taken upon himself the responsibility of furnishing the technical specifications.

3. In connection with the warranty of fitness for a particular purpose the provisions of this Article (Chapter) on the allocation or division of risks are particularly applicable in any transaction in which the purpose for which the goods are to be used combines requirements both as to the quality of the goods themselves and compliance with certain laws or regulations. How the risks are divided is a question of fact to be determined, where not expressly contained in the agreement, from the circumstances of contracting, usage of trade, course of performance and the like, matters which may constitute the "otherwise agreement" of the parties by which they may divide the risk or burden.

4. The absence from this section of the



language used in the Uniform Sales Act in referring to the seller, "whether he be the grower or manufacturer or not," is not intended to impose any requirement that the seller be a grower or manufacturer. Although normally the warranty will arise only where the seller is a merchant with the appropriate "skill or judgment," it can arise as to nonmerchants where this is justified by the particular circumstances.

5. The elimination of the "patent or other trade name" exception constitutes the major extension of the warranty of fitness which has been made by the cases and continued in this Article (Chapter). Under the present section the existence of a patent or other trade name and the designation of the article by that name, or indeed in any other definite manner, is only one of the facts to be considered on the question of whether the buyer actually relied on the seller, but it is not of itself decisive of the issue. If the buyer himself is insisting on a particular brand he is not relying on the seller's skill and judgment and so no warranty results. But the mere fact that the article purchased has a par-

ticular patent or trade name is not sufficient to indicate nonreliance if the article has been recommended by the seller as adequate for the buyer's purposes.

6. The specific reference forward in the present section to the following section on exclusion or modification of warranties is to call attention to the possibility of eliminating the warranty in any given case. However, it must be noted that under the following section the warranty of fitness for a particular purpose must be excluded or modified by a conspicuous writing.

#### *Cross References:*

Point 2: Sections 2-314 (A.C.A. § 4-2-314) and 2-317 (A.C.A. § 4-2-317).

Point 3: Section 2-303 (A.C.A. § 4-2-303).

Point 6: Section 2-316 (A.C.A. § 4-2-316).

#### *Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### **Comment to § 2-316 (A.C.A. § 4-2-316)\***

*Prior Uniform Statutory Provision:* None.

#### *Purposes:*

1. This section is designed principally to deal with those frequent clauses in sales contracts which seek to exclude "all warranties, express or implied." It seeks to protect a buyer from unexpected and unbargained language of disclaimer by denying effect to such language when inconsistent with language of express warranty and permitting the exclusion of implied warranties only by conspicuous language or other circumstances which protect the buyer from surprise.

2. The seller is protected under this Article (Chapter) against false allegations of oral warranties by its provisions on parol and extrinsic evidence and against unauthorized representations by the customary "lack of authority" clauses. This Article (Chapter) treats the limitation or avoidance of consequential damages as a matter of limiting remedies for breach, separate from the matter of creation of liability under a warranty. If no warranty exists, there is of course no problem of

limiting remedies for breach of warranty. Under subsection (4) (A.C.A. § 4-2-316(4)) the question of limitation of remedy is governed by the sections referred to rather than by this section.

3. Disclaimer of the implied warranty of merchantability is permitted under subsection (2) (A.C.A. § 4-2-316(2)), but with the safeguard that such disclaimers must mention merchantability and in case of a writing must be conspicuous.

4. Unlike the implied warranty of merchantability, implied warranties of fitness for a particular purpose may be excluded by general language, but only if it is in writing and conspicuous.

5. Subsection (2) (A.C.A. § 4-2-316(2)) presupposes that the implied warranty in question exists unless excluded or modified. Whether or not language of disclaimer satisfies the requirements of this section, such language may be relevant under other sections to the question whether the warranty was ever in fact created. Thus, unless the provisions of this Article (Chapter) on parol and extrinsic evidence prevent, oral language of dis-



claimant may raise issues of fact as to whether reliance by the buyer occurred and whether the seller had "reason to know" under the section on implied warranty of fitness for a particular purpose.

6. The exceptions to the general rule set forth in paragraphs (a), (b) and (c) of subsection (3) (A.C.A. § 4-2-316(3)(a), (b) and (c)) are common factual situations in which the circumstances surrounding the transaction are in themselves sufficient to call the buyer's attention to the fact that no implied warranties are made or that a certain implied warranty is being excluded.

7. Paragraph (a) of subsection (3) (A.C.A. § 4-2-316(3)(a)) deals with general terms such as "as is," "as they stand," "with all faults," and the like. Such terms in ordinary commercial usage are understood to mean that the buyer takes the entire risk as to the quality of the goods involved. The terms covered by paragraph (a) (A.C.A. § 4-2-316(3)(a)) are in fact merely a particularization of paragraph (c) (A.C.A. § 4-2-316(3)(c)) which provides for exclusion or modification of implied warranties by usage of trade.

8. Under paragraph (b) of subsection (3) (A.C.A. § 4-2-316(3)(b)) warranties may be excluded or modified by the circumstances where the buyer examines the goods or a sample or model of them before entering into the contract. "Examination" as used in this paragraph is not synonymous with inspection before acceptance or at any other time after the contract has been made. It goes rather to the nature of the responsibility assumed by the seller at the time of the making of the contract. Of course if the buyer discovers the defect and uses the goods anyway, or if he unreasonably fails to examine the goods before he uses them, resulting injuries may be found to result from his own action rather than proximately from a breach of warranty. See Sections 2-314 (A.C.A. § 4-2-314) and 2-715 (A.C.A. § 4-2-715) and comments thereto.

In order to bring the transaction within the scope of "refused to examine" in paragraph (b) (A.C.A. § 4-2-316(3)(b)), it is not sufficient that the goods are available for inspection. There must in addition be a demand by the seller that the buyer examine the goods fully. The seller by the demand puts the buyer on notice that he is assuming the risk of defects which the

examination ought to reveal. The language "refused to examine" in this paragraph is intended to make clear the necessity for such demand.

Application of the doctrine of "caveat emptor" in all cases where the buyer examines the goods regardless of statements made by the seller is, however, rejected by this Article (Chapter). Thus, if the offer of examination is accompanied by words as to their merchantability or specific attributes and the buyer indicates clearly that he is relying on those words rather than on his examination, they give rise to an "express" warranty. In such cases the question is one of fact as to whether a warranty of merchantability has been expressly incorporated in the agreement. Disclaimer of such an express warranty is governed by subsection (1) (A.C.A. § 4-2-316(1)) of the present section.

The particular buyer's skill and the normal method of examining goods in the circumstances determine what defects are excluded by the examination. A failure to notice defects which are obvious cannot excuse the buyer. However, an examination under circumstances which do not permit chemical or other testing of the goods would not exclude defects which could be ascertained only by such testing. Nor can latent defects be excluded by a simple examination. A professional buyer examining a product in his field will be held to have assumed the risk as to all defects which a professional in the field ought to observe, while a nonprofessional buyer will be held to have assumed the risk only for such defects as a layman might be expected to observe.

9. The situation in which the buyer gives precise and complete specifications to the seller is not explicitly covered in this section, but this is a frequent circumstance by which the implied warranties may be excluded. The warranty of fitness for a particular purpose would not normally arise since in such a situation there is usually no reliance on the seller by the buyer. The warranty of merchantability in such a transaction, however, must be considered in connection with the next section on the cumulation and conflict of warranties. Under paragraph (c) (A.C.A. § 4-2-316(3)(c)) of that section in case of such an inconsistency the implied warranty of merchantability is displaced by the express warranty that the goods will

comply with the specifications. Thus, where the buyer gives detailed specifications as to the goods, neither of the implied warranties as to quality will normally apply to the transaction unless consistent with the specifications.

*Cross References:*

Point 2: Sections 2-202 (A.C.A. § 4-2-202), 2-718 (A.C.A. § 4-2-718), and 2-719 (A.C.A. § 4-2-719).

Point 7: Sections 1-205 (A.C.A. § 4-1-205) and 2-208 (A.C.A. § 4-2-208).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Course of dealing". Section 1-205 (A.C.A. § 4-1-205).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Usage of trade". Section 1-205 (A.C.A. § 4-1-205).

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\*The Arkansas version of this section was amended by Acts 1969, No. 41, § 1, and 1981, No. 822, § 1, making it vary from this uniform act section.

**Comment to § 2-317 (A.C.A. § 4-2-317)**

*Prior Uniform Statutory Provision:* On cumulation of warranties, see Sections 14, 15, and 16, Uniform Sales Act.

*Changes:* Completely rewritten into one section.

*Purposes of Changes:*

1. The present section rests on the basic policy of this Article (Chapter) that no warranty is created except by some conduct (either affirmative action or failure to disclose) on the part of the seller. Therefore, all warranties are made cumulative unless this construction of the contract is impossible or unreasonable.

This Article (Chapter) thus follows the general policy of the Uniform Sales Act except that in case of the sale of an article by its patent or trade name the elimination of the warranty of fitness depends solely on whether the buyer has relied on the seller's skill and judgment; the use of the patent or trade name is but one factor in making this determination.

2. The rules of this section are designed to aid in determining the intention of the parties as to which of inconsistent warranties which have arisen from the circumstances of their transaction shall pre-

vail. These rules of intention are to be applied only where factors making for an equitable estoppel of the seller do not exist and where he has in perfect good faith made warranties which later turn out to be inconsistent. To the extent that the seller has led the buyer to believe that all of the warranties can be performed, he is estopped from setting up any essential inconsistency as a defense.

3. The rules in subsections (a), (b) and (c) (A.C.A. § 4-2-317(a), (b), and (c)) are designed to ascertain the intention of the parties by reference to the factor which probably claimed the attention of the parties in the first instance. These rules are not absolute but may be changed by evidence showing that the conditions which existed at the time of contracting make the construction called for by the section inconsistent or unreasonable.

*Cross Reference:*

Point 1: Section 2-315 (A.C.A. § 4-2-315).

*Definitional Cross Reference:*

"Party". Section 1-201 (A.C.A. § 4-1-201).



**Comment to § 2-318 (A.C.A. § 4-2-318)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. The last sentence of this section does not mean that a seller is precluded from excluding or disclaiming a warranty which might otherwise arise in connection with the sale provided such exclusion or modification is permitted by Section 2-316 (A.C.A. § 4-2-316). Nor does that sentence preclude the seller from limiting the remedies of his own buyer and of any beneficiaries, in any manner provided in Sections 2-718 (A.C.A. § 4-2-718) or 2-719 (A.C.A. § 4-2-719). To the extent that the contract of sale contains provisions under which warranties are excluded or modified, or remedies for breach are limited, such provisions are equally operative against beneficiaries of warranties under this section. What this last sentence forbids is exclusion of liability by the seller to the persons to whom the warranties which he has made to his buyer would extend under this section.

2. The purpose of this section is to give the buyer's family, household and guests the benefit of the same warranty which the buyer received in the contract of sale, thereby freeing any such beneficiaries from any technical rules as to "privity." It seeks to accomplish this purpose without any derogation of any right or remedy resting on negligence. It rests primarily

upon the merchant-seller's warranty under this Article (Chapter) that the goods sold are merchantable and fit for the ordinary purposes for which such goods are used rather than the warranty of fitness for a particular purpose. Implicit in the section is that any beneficiary of a warranty may bring a direct action for breach of warranty against the seller whose warranty extends to him.

3. This section expressly includes as beneficiaries within its provisions the family, household, and guests of the purchaser. Beyond this, the section is neutral and is not intended to enlarge or restrict the developing case law on whether the seller's warranties, given to his buyer who resells, extend to other persons in the distributive chain.

*Cross References:*

Point 1: Sections 2-316 (A.C.A. § 4-2-316), 2-718 (A.C.A. § 4-2-718) and 2-719 (A.C.A. § 4-2-719).

Point 2: Section 2-314 (A.C.A. § 4-2-314).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-319 (A.C.A. § 4-2-319)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. This section is intended to negate the uncommercial line of decision which treats an "F.O.B." term as "merely a price term." The distinctions taken in subsection (1) (A.C.A. § 4-2-319(1)) handle most of the issues which have on occasion led to the unfortunate judicial language just referred to. Other matters which have led to sound results being based on unhappy language in regard to F.O.B. clauses are dealt with in this Act by Section 2-311(2) (A.C.A. § 4-2-311(2)) (seller's option re arrangements relating to shipment) and Sections 2-614 (A.C.A. § 4-2-614) and 2-615 (A.C.A. § 4-2-615) (substituted performance and seller's excuse).

2. Subsection (1)(c) (A.C.A. § 4-2-319(1)(c)) not only specifies the duties of a seller who engages to deliver "F.O.B. vessel," or the like, but ought to make clear that no agreement is soundly drawn when it looks to reshipment from San Francisco or New York, but speaks merely of "F.O.B." the place.

3. The buyer's obligations stated in subsection (1)(c) (A.C.A. § 4-2-319(1)(c)) and subsection (3) (A.C.A. § 4-2-319(3)) are, as shown in the text, obligations of cooperation. The last sentence of subsection (3) (A.C.A. § 4-2-319(3)) expressly, though perhaps unnecessarily, authorizes the seller, pending instructions, to go ahead with such preparatory moves as shipment from the interior to the named point of delivery. The sentence presup-



poses the usual case in which instructions "fail"; a prior repudiation by the buyer, giving notice that breach was intended, would remove the reason for the sentence, and would normally bring into play, instead, the second sentence of Section 2-704 (A.C.A. § 4-2-704), which duly calls for lessening damages.

4. The treatment of "F.O.B. vessel" in conjunction with F.A.S. fits, in regard to the need for payment against documents, with standard practice and case-law; but "F.O.B. vessel" is a term which by its very language makes express the need for an "on board" document. In this respect, that term is stricter than the ordinary overseas "shipment" contract (C.I.F., etc., Section 2-320 (A.C.A. § 4-2-320)).

*Cross References:*

Sections 2-311(3) (A.C.A. § 4-2-311(3)),

2-323 (A.C.A. § 4-2-323), 2-503 (A.C.A. § 4-2-503) and 2-504 (A.C.A. § 4-2-504).

*Definitional Cross References:*

"Agreed". Section 1-201 (A.C.A. § 4-1-201).

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-320 (A.C.A. § 4-2-320)**

*Prior Uniform Statutory Provision:* None.

*Purposes:* To make it clear that:

1. The C.I.F. contract is not a destination but a shipment contract with risk of subsequent loss or damage to the goods passing to the buyer upon shipment if the seller has properly performed all his obligations with respect to the goods. Delivery to the carrier is delivery to the buyer for purposes of risk and "title". Delivery of possession of the goods is accomplished by delivery of the bill of lading, and upon tender of the required documents the buyer must pay the agreed price without awaiting the arrival of the goods and if they have been lost or damaged after proper shipment he must seek his remedy against the carrier or insurer. The buyer has no right of inspection prior to payment or acceptance of the documents.

2. The seller's obligations remain the same even though the C.I.F. term is "used only in connection with the stated price and destination".

3. The insurance stipulated by the C.I.F. term is for the buyer's benefit, to protect him against the risk of loss or damage to the goods in transit. A clause in a C.I.F. contract "insurance — for the account of sellers" should be viewed in its ordinary mercantile meaning that the sellers must pay for the insurance and not that it is intended to run to the seller's benefit.

4. A bill of lading covering the entire

transportation from the port of shipment is explicitly required by the provision on this point must be read in the light of its reason to assure the buyer of as full protection as the conditions of shipment reasonably permit, remembering always that this type of contract is designed to move the goods in the channels commercially available. To enable the buyer to deal with the goods while they are afloat the bill of lading must be one that covers only the quantity of goods called for by the contract. The buyer is not required to accept his part of the goods without a bill of lading because the latter covers a larger quantity, nor is he required to accept a bill of lading for the whole quantity under a stipulation to hold the excess for the owner. Although the buyer is not compelled to accept either goods or documents under such circumstances he may of course claim his rights in any goods which have been identified to his contract.

5. The seller is given the option of paying or providing for the payment of freight. He has no option to ship "freight collect" unless the agreement so provides. The rule of the common law that the buyer need not pay the freight if the goods do not arrive is preserved.

Unless the shipment has been sent "freight collect" the buyer is entitled to receive documentary evidence that he is not obligated to pay the freight; the seller is therefore required to obtain a receipt

"showing that the freight has been paid or provided for." The usual notation in the appropriate space on the bill of lading that the freight has been prepaid is a sufficient receipt, as at common law. The phrase "provided for" is intended to cover the frequent situation in which the carrier extends credit to a shipper for the freight on successive shipments and receives periodical payments of the accrued freight charges from him.

6. The requirement that unless otherwise agreed the seller must procure insurance "of a kind and on terms then current at the port for shipment in the usual amount, in the currency of the contract, sufficiently shown to cover the same goods covered by the bill of lading", applies to both marine and war risk insurance. As applied to marine insurance, it means such insurance as is usual or customary at the port for shipment with reference to the particular kind of goods involved, the character and equipment of the vessel, the route of the voyage, the port of destination and any other considerations that affect the risk. It is the substantial equivalent of the ordinary insurance in the particular trade and on the particular voyage and is subject to agreed specifications of type or extent of coverage. The language does not mean that the insurance must be adequate to cover all risks to which the goods may be subject in transit. There are some types of loss or damage that are not covered by the usual marine insurance and are excepted in bills of lading or in applicable statutes from the causes of loss or damage for which the carrier or the vessel is liable. Such risks must be borne by the buyer under this Article (Chapter).

Insurance secured in compliance with a C.I.F. term must cover the entire transportation of the goods to the named destination.

7. An additional obligation is imposed upon the seller in requiring him to procure customary war risk insurance at the buyer's expense. This changes the common law on the point. The seller is not required to assume the risk of including in the C.I.F. price the cost of such insurance, since it often fluctuates rapidly, but is required to treat it simply as a necessary for the buyer's account. What war risk insurance is "current" or usual turns on the standard forms of policy or rider in common use.

8. The C.I.F. contract calls for insurance covering the value of the goods at the time and place of shipment and does not include any increase in market value during transit or any anticipated profit to the buyer on a sale by him.

The contract contemplates that before the goods arrive at their destination they may be sold again and again on C.I.F. terms and that the original policy of insurance and bill of lading will run with the interest in the goods by being transferred to each successive buyer. A buyer who becomes the seller in such an intermediate contract for sale does not thereby, if his sub-buyer knows the circumstances, undertake to insure the goods again at an increased price fixed in the new contract or to cover the increase in price by additional insurance, and his buyer may not reject the documents on the ground that the original policy does not cover such higher price. If such a sub-buyer desires additional insurance he must procure it for himself.

Where the seller exercises an option to ship "freight collect" and to credit the buyer with the freight against the C.I.F. price, the insurance need not cover the freight since the freight is not at the buyer's risk. On the other hand, where the seller prepays the freight upon shipping under a bill of lading requiring prepayment and providing that the freight shall be deemed earned and shall be retained by the carrier "ship and/or cargo lost or not lost," or using words of similar import, he must procure insurance that will cover the freight, because notwithstanding that the goods are lost in transit the buyer is bound to pay the freight as part of the C.I.F. price and will be unable to recover it back from the carrier.

9. Insurance "for the account of whom it may concern" is usual and sufficient. However, for a valid tender the policy of insurance must be one which can be disposed of together with the bill of lading and so must be "sufficiently shown to cover the same goods covered by the bill of lading." It must cover separately the quantity of goods called for by the buyer's contract and not merely insure his goods as part of a larger quantity in which others are interested, a case provided for in American mercantile practice by the use of negotiable certificates of insurance



which are expressly authorized by this section. By usage these certificates are treated as the equivalent of separate policies and are good tender under C.I.F. contracts. The term "certificate of insurance", however, does not of itself include certificates or "cover notes" issued by the insurance broker and stating that the goods are covered by a policy. Their sufficiency as substitutes for policies will depend upon proof of an established usage or course of dealing. The present section rejects the English rule that not only brokers' certificates and "cover notes" but also certain forms of American insurance certificates are not the equivalent of policies and are not good tender under a C.I.F. contract.

The seller's failure to tender a proper insurance document is waived if the buyer refuses to make payment on other and untenable grounds at a time when proper insurance could have been obtained and tendered by the seller if timely objection had been made. Even a failure to insure on shipment may be cured by seasonable tender of a policy retroactive in effect; e.g., one insuring the goods "lost or not lost." The provisions of this Article (Chapter) on cure of improper tender and on waiver of buyer's objections by silence are applicable to insurance tenders under a C.I.F. term. Where there is no waiver by the buyer as described above, however, the fact that the goods arrive safely does not cure the seller's breach of his obligations to insure them and tender to the buyer a proper insurance document.

10. The seller's invoice of the goods shipped under a C.I.F. contract is regarded as a usual and necessary document upon which reliance may properly be placed. It is the document which evidences points of description, quality and the like which do not readily appear in other documents. This Article (Chapter) rejects those statements to the effect that the invoice is a usual but not a necessary document under a C.I.F. term.

11. The buyer needs all of the documents required under a C.I.F. contract, in due form and with necessary endorsements, so that before the goods arrive he may deal with them by negotiating the documents or may obtain prompt possession of the goods after their arrival. If the goods are lost or damaged in transit the

documents are necessary to enable him promptly to assert his remedy against the carrier or insurer. The seller is therefore obligated to do what is mercantilely reasonable in the circumstances and should make every reasonable exertion to send forward the documents as soon as possible after the shipment. The requirement that the documents be forwarded with "commercial promptness" expresses a more urgent need for action than that suggested by the phrase "reasonable time".

12. Under a C.I.F. contract the buyer, as under the common law, must pay the price upon tender of the required documents without first inspecting the goods, but his payment in these circumstances does not constitute an acceptance of the goods nor does it impair his right of subsequent inspection or his options and remedies in the case of improper delivery. All remedies and rights for the seller's breach are reserved to him. The buyer must pay before inspection and assert his remedy against the seller afterward unless the nonconformity of the goods amounts to a real failure of consideration since the purpose of choosing this form of contract is to give the seller protection against the buyer's unjustifiable rejection of the goods at a distant port of destination which would necessitate taking possession of the goods and suing the buyer there.

13. A valid C.I.F. contract may be made which requires part of the transportation to be made on land and part on the sea, as where the goods are to be brought by rail from an inland point to a seaport and thence transported by vessel to the named destination under a "through" or combination bill of lading issued by the railroad company. In such a case shipment by rail from the inland point within the contract period is a timely shipment notwithstanding that the loading of the goods on the vessel is delayed by causes beyond the seller's control.

14. Although subsection (2) (A.C.A. § 4-2-320(2)) stating the legal effects of the C.I.F. term is an "unless otherwise agreed" provision, the express language used in an agreement is frequently a precautionary, fuller statement of the normal C.I.F. terms and hence not intended as a departure or variation from them. Moreover, the dominant outlines of the C.I.F. term are so well understood commercially that any variation should, whenever rea-



sonably possible, be read as falling within those dominant outlines rather than as destroying the whole meaning of a term which essentially indicates a contract for proper shipment rather than one for delivery at destination. Particularly careful consideration is necessary before a printed form or clause is construed to mean agreement otherwise and where a C.I.F. contract is prepared on a printed form designed for some other type of contract, the C.I.F. terms must prevail over printed clauses repugnant to them.

15. Under subsection (4) (A.C.A. § 4-2-320(4)) the fact that the seller knows at the time of the tender of the documents that the goods have been lost in transit does not affect his rights if he has performed his contractual obligations. Similarly, the seller cannot perform under a C.I.F. term by purchasing and tendering landed goods.

16. Under the C. & F. term, as under the C.I.F. term, title and risk of loss are intended to pass to the buyer on shipment. A stipulation in a C. & F. contract that the seller shall effect insurance on the goods and charge the buyer with the premium (in effect that he shall act as the buyer's agent for that purpose) is entirely in keeping with the pattern. On the other hand, it often happens that the buyer is in a more advantageous position than the seller to effect insurance on the goods or that he has in force an "open" or "floating" policy covering all shipments made by him or to him, in either of which events the C. & F.

term is adequate without mention of insurance.

17. It is to be remembered that in a French contract the term "C.A.F." does not mean "Cost and Freight" but has exactly the same meaning as the term "C.I.F." since it is merely the French equivalent of that term. The "A" does not stand for "and" but for "assurance" which means insurance.

*Cross References:*

Point 4: Section 2-323 (A.C.A. § 4-2-323).

Point 6: Section 2-509(1)(a) (A.C.A. § 4-2-509(1)(a)).

Point 9: Sections 2-508 (A.C.A. § 4-2-508) and 2-605(1)(a) (A.C.A. § 4-2-605(1)(a)).

Point 12: Sections 2-321(3) (A.C.A. § 4-2-321(3)), 2-512 (A.C.A. § 4-2-512) and 2-513(3) (A.C.A. § 4-2-513(3)) and Article 5 (Chapter 5).

*Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-321 (A.C.A. § 4-2-321)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

This section deals with two variations of the C.I.F. contract which have evolved in mercantile practice but are entirely consistent with the basic C.I.F. pattern. Subsections (1) (A.C.A. § 4-2-321(1)) and (2) (A.C.A. § 4-2-321(2)), which provide for a shift to the seller of the risk of quality and weight deterioration during shipment, are designed to conform the law to the best mercantile practice and usage without changing the legal consequences of the C.I.F. or C. & F. term as to the passing of marine risks to the buyer at the point of shipment. Subsection (3) (A.C.A. § 4-2-321(3)) provides that where under the

contract documents are to be presented for payment after arrival of the goods, this amounts merely to a postponement of the payment under the C.I.F. contract and is not to be confused with the "no arrival, no sale" contract. If the goods are lost, delivery of the documents and payment against them are due when the goods should have arrived. The clause for payment on or after arrival is not to be construed as such a condition precedent to payment that if the goods are lost in transit the buyer need never pay and the seller must bear the loss.

*Cross Reference:*

Section 2-324 (A.C.A. § 4-2-324).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-322 (A.C.A. § 4-2-322)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. The delivery term, "ex ship", as between seller and buyer, is the reverse of the f.a.s. term covered.

2. Delivery need not be made from any particular vessel under a clause calling for delivery "ex ship", even though a vessel on which shipment is to be made originally is named in the contract, unless the agreement by appropriate language, restricts the clause to delivery from a named vessel.

3. The appropriate place and manner of unloading at the port of destination depend upon the nature of the goods and the facilities and usages of the port.

4. A contract fixing a price "ex ship" with payment "cash against documents" calls only for such documents as are appropriate to the contract. Tender of a de-

livery order and of a receipt for the freight after the arrival of the carrying vessel is adequate. The seller is not required to tender a bill of lading as a document of title nor is he required to insure the goods for the buyer's benefit, as the goods are not at the buyer's risk during the voyage.

*Cross Reference:*

Point 1: Section 2-319(2) (A.C.A. § 4-2-319(2)).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-323 (A.C.A. § 4-2-323)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-2-323(1)) follows the "American" rule that a regular bill of lading indicating delivery of the goods at the dock for shipment is sufficient, except under a term "F.O.B. vessel." See Section 2-319 (A.C.A. § 4-2-319) and comment thereto.

2. Subsection (2) (A.C.A. § 4-2-323(2)) deals with the problem of bills of lading covering deep water shipments, issued not as a single bill of lading but in a set of parts, each part referring to the other parts and the entire set constituting in commercial practice and at law a single bill of lading. Commercial practice in international commerce is to accept and pay against presentation of the first part of a set if the part is sent from overseas even though the contract of the buyer requires

presentation of a full set of bills of lading provided adequate indemnity for the missing parts is forthcoming.

This subsection codifies that practice as between buyer and seller. Article 5 (Chapter 5) (Section 5-113 (A.C.A. § 4-5-113)) authorizes banks presenting drafts under letters of credit to give indemnities against the missing parts, and this subsection means that the buyer must accept and act on such indemnities if he in good faith deems them adequate. But neither this subsection nor Article 5 (Chapter 5) decides whether a bank which has issued a letter of credit is similarly bound. The issuing bank's obligation under a letter of credit is independent and depends on its own terms. See Article 5 (Chapter 5).

*Cross References:*

Sections 2-508(2) (A.C.A. § 4-2-508(2)), 5-113 (A.C.A. § 4-5-113).



*Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Financing agency". Section 2-104 (A.C.A. § 4-2-104).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-324 (A.C.A. § 4-2-324)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. The "no arrival, no sale" term in a "destination" overseas contract leaves risk of loss on the seller but gives him an exemption from liability for nondelivery. Both the nature of the case and the duty of good faith require that the seller must not interfere with the arrival of the goods in any way. If the circumstances impose upon him the responsibility for making or arranging the shipment, he must have a shipment made despite the exemption clause. Further, the shipment made must be a conforming one, for the exemption under a "no arrival, no sale" term applies only to the hazards of transportation and the goods must be proper in all other respects.

The reason of this section is that where the seller is reselling goods bought by him as shipped by another and this fact is known to the buyer, so that the seller is not under any obligation to make the shipment himself, the seller is entitled under the "no arrival, no sale" clause to exemption from payment of damages for nondelivery if the goods do not arrive or if the goods which actually arrive are non-conforming. This does not extend to sellers who arrange shipment by their own agents, in which case the clause is limited to casualty due to marine hazards. But sellers who make known that they are contracting only with respect to what will be delivered to them by parties over whom they assume no control are entitled to the full quantum of the exemption.

2. The provisions of this Article (Chapter) on identification must be read together with the present section in order to bring the exemption into application. Until there is some designation of the goods

in a particular shipment or on a particular ship as being those to which the contract refers there can be no application of an exemption for their non-arrival.

3. The seller's duty to tender the agreed or declared goods if they do arrive is not impaired because of their delay in arrival or by their arrival after transshipment.

4. The phrase "to arrive" is often employed in the same sense as "no arrival, no sale" and may then be given the same effect. But a "to arrive" term, added to a C.I.F. or C. & F. contract, does not have the full meaning given by this section to "no arrival, no sale". Such a "to arrive" term is usually intended to operate only to the extent that the risks are not covered by the agreed insurance and the loss or casualty is due to such uncovered hazards. In some instances the "to arrive" term may be regarded as a time of payment term, or, in the case of the reselling seller discussed in point 1 above, as negating responsibility for conformity of the goods, if they arrive, to any description which was based on his good faith belief of the quality. Whether this is the intention of the parties is a question of fact based on all the circumstances surrounding the resale and in case of ambiguity the rules of Sections 2-316 (A.C.A. § 4-2-316) and 2-317 (A.C.A. § 4-2-317) apply to preclude dishonor.

5. Paragraph (b) (A.C.A. § 4-2-324(b)) applies where goods arrive impaired by damage or partial loss during transportation and makes the policy of this Article (Chapter) on casualty to identified goods applicable to such a situation. For the term cannot be regarded as intending to give the seller an unforeseen profit through casualty; it is intended only to protect him from loss due to causes beyond his control.



*Cross References:*

Point 1: Section 1-203 (A.C.A. § 4-1-203).

Point 2: Section 2-501(1)(a) (A.C.A. § 4-2-501(1)(a)) and (1)(c) (A.C.A. § 4-2-501(1)(c)).

Point 5: Section 2-613 (A.C.A. § 4-2-613).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conforming". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Fault". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-325 (A.C.A. § 4-2-325)**

*Prior Uniform Statutory Provision:* None.

*Purposes:* To express the established commercial and banking understanding as to the meaning and effects of terms calling for "letters of credit" or "confirmed credit":

1. Subsection (2) (A.C.A. § 4-2-325(2)) follows the general policy of this Article (Chapter) and Article 3 (Chapter 3) (Section 3-802 (A.C.A. § 4-3-802)) on conditional payment, under which payment by check or other short-term instrument is not ordinarily final as between the parties if the recipient duly presents the instrument and honor is refused. Thus the furnishing of a letter of credit does not substitute the financing agency's obligation for the buyer's, but the seller must first give the buyer reasonable notice of his intention to demand direct payment from him.

2. Subsection (3) (A.C.A. § 4-2-325(3)) requires that the credit be irrevocable and be a prime credit as determined by the standing of the issuer. It is not necessary, unless otherwise agreed, that the credit be a negotiation credit; the seller can finance himself by an assignment of the proceeds under Section 5-116(2) (A.C.A. § 4-5-116(2)).

3. The definition of "confirmed credit" is drawn on the supposition that the credit is

issued by a bank which is not doing direct business in the seller's financial market; there is no intention to require the obligation of two banks both local to the seller.

*Cross References:*

Sections 2-403 (A.C.A. § 4-2-403), 2-511(3) (A.C.A. § 4-2-511(3)) and 3-802 (A.C.A. § 4-3-802) and Article 5 (Chapter 5).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Financing agency". Section 2-104 (A.C.A. § 4-2-104).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Overseas". Section 2-323 (A.C.A. § 4-2-323).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-326 (A.C.A. § 4-2-326)\***

*Prior Uniform Statutory Provision:* Section 19(3), Uniform Sales Act.

*Changes:* Completely rewritten in this and the succeeding section.

*Purposes of Changes:* To make it clear that:

1. A "sale on approval" or "sale or return" is distinct from other types of transactions with which they have frequently

been confused. The type of "sale on approval," "on trial" or "on satisfaction" dealt with involves a contract under which the seller undertakes a particular business risk to satisfy his prospective buyer with the appearance or performance of the goods in question. The goods are delivered to the proposed purchaser but they remain the property of the seller until the buyer accepts them. The price has already been agreed. The buyer's willingness to receive and test the goods is the consideration for the seller's engagement to deliver and sell. The type of "sale or return" involved herein is a sale to a merchant whose unwillingness to buy is overcome only by the seller's engagement to take back the goods (or any commercial unit of goods) in lieu of payment if they fail to be resold. These two transactions are so strongly delineated in practice and in general understanding that every presumption runs against a delivery to a consumer being a "sale or return" and against a delivery to a merchant for resale being a "sale on approval."

The right to return the goods for failure to conform to the contract does not make the transaction a "sale on approval" or "sale or return" and has nothing to do with this and the following section. The present section is not concerned with remedies for breach of contract. It deals instead with a power given by the contract to turn back the goods even though they are wholly as warranted.

This section nevertheless presupposes that a contract for sale is contemplated by the parties although that contract may be of the peculiar character here described.

Where the buyer's obligation as a buyer is conditioned not on his personal approval but on the article's passing a described objective test, the risk of loss by casualty pending the test is properly the seller's and proper return is at his expense. On the point of "satisfaction" as meaning "reasonable satisfaction" where an industrial machine is involved, this Article (Chapter) takes no position.

2. Pursuant to the general policies of this Act which require good faith not only between the parties to the sales contract, but as against interested third parties, subsection (3) (A.C.A. § 4-2-326(3)) resolves all reasonable doubts as to the nature of the transaction in favor of the general creditors of the buyer. As against such creditors words such as "on consignment" or "on memorandum", with or with-

out words of reservation of title in the seller, are disregarded when the buyer has a place of business at which he deals in goods of the kind involved. A necessary exception is made where the buyer is known to be engaged primarily in selling the goods of others or is selling under a relevant sign law, or the seller complies with the filing provisions of Article 9 (Chapter 9) as if his interest were a security interest. However, there is no intent in this Section to narrow the protection afforded to third parties in any jurisdiction which has a selling Factors Act. The purpose of the exception is merely to limit the effect of the present subsection itself, in the absence of any such Factors Act, to cases in which creditors of the buyer may reasonably be deemed to have been misled by the secret reservation.

3. Subsection (4) (A.C.A. § 4-2-326(4)) resolves a conflict in the preexisting case law by recognition that an "or return" provision is so definitely at odds with any ordinary contract for sale of goods that where written agreements are involved it must be contained in a written memorandum. The "or return" aspect of a sales contract must be treated as a separate contract under the Statute of Frauds section and as contradicting the sale insofar as questions of parol or extrinsic evidence are concerned.

#### *Cross References:*

Point 2: Article 9 (Chapter 9).

Point 3: Sections 2-201 (A.C.A. § 4-2-201) and 2-202 (A.C.A. § 4-2-202).

#### *Definitional Cross References:*

"Between merchants". Section 2-104 (A.C.A. § 4-2-104).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

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\*The Arkansas version of this section was amended by Acts 1983, No. 820, § 7, making it vary from this uniform act section.



**Comment to § 2-327 (A.C.A. § 4-2-327)**

*Prior Uniform Statutory Provision:* Section 19(3), Uniform Sales Act.

*Changes:* Completely rewritten in preceding and this section.

*Purposes of Changes:* To make it clear that:

1. In the case of a sale on approval:

If all of the goods involved conform to the contract, the buyer's acceptance of part of the goods constitutes acceptance of the whole. Acceptance of part falls outside the normal intent of the parties in the "on approval" situation and the policy of this Article (Chapter) allowing partial acceptance of a defective delivery has no application here. A case where a buyer takes home two dresses to select one commonly involves two distinct contracts; if not, it is covered by the words "unless otherwise agreed".

2. In the case of a sale or return, the return of any unsold unit merely because it is unsold is the normal intent of the "sale or return" provision, and therefore the right to return for this reason alone is independent of any other action under the contract which would turn on wholly different considerations. On the other hand, where the return of goods is for breach, including return of items resold by the buyer and returned by the ultimate purchasers because of defects, the return procedure is governed not by the present section but by the provisions on the effects and revocation of acceptance.

3. In the case of a sale on approval the risk rests on the seller until acceptance of the goods by the buyer, while in a sale or return the risk remains throughout on the buyer.

4. Notice of election to return given by the buyer in a sale on approval is sufficient to relieve him of any further liability. Actual return by the buyer to the seller is required in the case of a sale or return

contract. What constitutes due "giving" of notice, as required in "on approval" sales, is governed by the provisions on good faith and notice. "Seasonable" is used here as defined in Section 1-204 (A.C.A. § 4-1-204). Nevertheless, the provisions of both this Article (Chapter) and of the contract on this point must be read with commercial reason and with full attention to good faith.

*Cross References:*

Point 1: Sections 2-501 (A.C.A. § 4-2-501), 2-601 (A.C.A. § 4-2-601) and 2-603 (A.C.A. § 4-2-603).

Point 2: Sections 2-607 (A.C.A. § 4-2-607) and 2-608 (A.C.A. § 4-2-608).

Point 4: Sections 1-201 (A.C.A. § 4-1-201) and 1-204 (A.C.A. § 4-1-204).

*Definitional Cross References:*

"Agreed". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Commercial unit". Section 2-105 (A.C.A. § 4-2-105).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Merchant". Section 2-104 (A.C.A. § 4-2-104).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Sale on approval". Section 2-326 (A.C.A. § 4-2-326).

"Sale or return". Section 2-326 (A.C.A. § 4-2-326).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-328 (A.C.A. § 4-2-328)**

*Prior Uniform Statutory Provision:* Section 21, Uniform Sales Act.

*Changes:* Completely rewritten.

*Purposes of Changes:* To make it clear that:

1. The auctioneer may in his discretion either reopen the bidding or close the sale on the bid on which the hammer was falling when a bid is made at that moment. The recognition of a bid of this kind by the auctioneer in his discretion does



not mean a closing in favor of such a bidder, but only that the bid has been accepted as a continuation of the bidding. If recognized, such a bid discharges the bid on which the hammer was falling when it was made.

2. An auction "with reserve" is the normal procedure. The crucial point, however, for determining the nature of an auction is the "putting up" of the goods. This Article (Chapter) accepts the view that the goods may be withdrawn before they are actually "put up," regardless of whether the auction is advertised as one without reserve, without liability on the part of the auction announcer to persons who are present. This is subject to any peculiar facts which might bring the case within the "firm offer" principle of this Article (Chapter), but an offer to persons generally would require unmistakable language in order to fall within that section. The prior announcement of the nature of the auction either as with reserve or without reserve will, however, enter as

an "explicit term" in the "putting up" of the goods and conduct thereafter must be governed accordingly. The present section continues the prior rule permitting withdrawal of bids in auctions both with and without reserve; and the rule is made explicit that the retraction of a bid does not revive a prior bid.

*Cross Reference:*

Point 2: Section 2-205 (A.C.A. § 4-2-205).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Lot". Section 2-105 (A.C.A. § 4-2-105).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-401 (A.C.A. § 4-2-401)**

*Prior Uniform Statutory Provision:* See generally, Sections 17, 18, 19 and 20, Uniform Sales Act.

*Purposes:* To make it clear that:

1. This Article (Chapter) deals with the issues between seller and buyer in terms of step by step performance or non-performance under the contract for sale and not in terms of whether or not "title" to the goods has passed. That the rules of this section in no way alter the rights of either the buyer, seller or third parties declared elsewhere in the Article (Chapter) is made clear by the preamble of this section. This section, however, in no way intends to indicate which line of interpretation should be followed in cases where the applicability of "public" regulation depends upon a "sale" or upon location of "title" without further definition. The basic policy of this Article (Chapter) that known purpose and reason should govern interpretation cannot extend beyond the scope of its own provisions. It is therefore necessary to state what a "sale" is and when title passes under this Article (Chapter) in case the courts deem any public regulation to incorporate the defined term of the "private" law.

2. "Future" goods cannot be the subject of a present sale. Before title can pass the goods must be identified in the manner set forth in Section 2-501 (A.C.A. § 4-2-501). The parties, however, have full liberty to arrange by specific terms for the passing of title to goods which are existing.

3. The "special property" of the buyer in goods identified to the contract is excluded from the definition of "security interest"; its incidents are defined in provisions of this Article (Chapter) such as those on the rights of the seller's creditors, on good faith purchase, on the buyer's right to goods on the seller's insolvency, and on the buyer's right to specific performance or replevin.

4. The factual situations in subsections (2) (A.C.A. § 4-2-401(2)) and (3) (A.C.A. § 4-2-401(3)) upon which passage of title turn actually base the test upon the time when the seller has finally committed himself in regard to specific goods. Thus in a "shipment" contract he commits himself by the act of making the shipment. If shipment is not contemplated subsection (3) (A.C.A. § 4-2-401(3)) turns on the seller's final commitment, i.e. the delivery of documents or the making of the contract.

*Cross References:*

Point 2: Sections 2-102 (A.C.A. § 4-2-102), 2-501 (A.C.A. § 4-2-501) and 2-502 (A.C.A. § 4-2-502).

Point 3: Sections 1-201 (A.C.A. § 4-1-201), 2-402 (A.C.A. § 4-2-402), 2-403 (A.C.A. § 4-2-403), 2-502 (A.C.A. § 4-2-502) and 2-716 (A.C.A. § 4-2-716).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Send". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-402 (A.C.A. § 4-2-402)**

*Prior Uniform Statutory Provision:* Subsection (2) (A.C.A. § 4-2-402(2)) — Section 26, Uniform Sales Act; Subsections (1) (A.C.A. § 4-2-402(1)) and (3) (A.C.A. § 4-2-402(3)) — none.

*Changes:* Rephrased.

*Purposes of Changes and New Matter:* To avoid confusion on ordinary issues between current sellers and buyers and issuers in the field of preference and hindrance by making it clear that:

1. Local law on question of hindrance of creditors by the seller's retention of possession of the goods are outside the scope of this Article (Chapter), but retention of possession in the current course of trade is legitimate. Transactions which fall within the law's policy against improper preferences are reserved from the protection of this Article (Chapter).

2. The retention of possession of the goods by a merchant seller for a commercially reasonable time after a sale or identification in current course is exempted from attack as fraudulent. Similarly, the

provisions of subsection (3) (A.C.A. § 4-2-402(3)) have no application to identification or delivery made in the current course of trade, as measured against general commercial understanding of what a "current" transaction is.

*Definitional Cross References:*

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Merchant". Section 2-104 (A.C.A. § 4-2-104).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

"Seller". Section 2-103 (A.C.A. § 4-2-103).



**Comment to § 2-403 (A.C.A. § 4-2-403)\***

*Prior Uniform Statutory Provision:* Sections 20(4), 23, 24, 25, Uniform Sales Act; Section 9, especially 9(2), Uniform Trust Receipts Act; Section 9, Uniform Conditional Sales Act.

*Changes:* Consolidated and rewritten.

*Purposes of Changes:* To gather together a series of prior uniform statutory provisions and the case-law thereunder and to state a unified and simplified policy on good faith purchase of goods.

1. The basic policy of our law allowing transfer of such title as the transferor has is generally continued and expanded under subsection (1) (A.C.A. § 4-2-403(1)). In this respect the provisions of the section are applicable to a person taking by any form of "purchase" as defined by this Act. Moreover the policy of this Act expressly providing for the application of supplementary general principles of law to sales transactions wherever appropriate joins with the present section to continue unimpaired all rights acquired under the law of agency or of apparent agency or ownership or other estoppel, whether based on statutory provisions or on case law principles. The section also leaves unimpaired the powers given to selling factors under the earlier Factors Acts. In addition subsection (1) (A.C.A. § 4-2-403(1)) provides specifically for the protection of the good faith purchaser for value in a number of specific situations which have been troublesome under prior law.

On the other hand, the contract of purchase is of course limited by its own terms as in a case of pledge for a limited amount or of sale of a fractional interest in goods.

2. The many particular situations in which a buyer in ordinary course of business from a dealer has been protected against reservation of property or other hidden interest are gathered by subsections (2)-(4) (A.C.A. § 4-2-403(2)-(4)) into a single principle protecting persons who buy in ordinary course out of inventory. Consignors have no reason to complain, nor have lenders who hold a security interest in the inventory, since the very purpose of goods in inventory is to be turned into cash by sale.

The principle is extended in subsection (3) (A.C.A. § 4-2-403(3)) to fit with the abolition of the old law of "cash sale" by subsection (1)(c) (A.C.A. § 4-2-403(1)(c)). It is also freed from any technicalities depending on the extended law of larceny; such extension of the concept of theft to include trick, particular types of fraud, and the like is for the purpose of helping conviction of the offender; it has no proper application to the long-standing policy of civil protection of buyers from persons guilty of such trick or fraud. Finally, the policy is extended, in the interest of simplicity and sense, to any entrusting by a bailor; this is in consonance with the explicit provisions of Section 7-205 (A.C.A. § 4-7-205) on the powers of a warehouseman who is also in the business of buying and selling fungible goods of the kind he warehouses. As to entrusting by a secured party, subsection (2) (A.C.A. § 4-2-403(2)) is limited by the more specific provisions of Section 9-307(1) (A.C.A. § 4-9-307(1)), which deny protection to a person buying farm products from a person engaged in farming operations.

3. The definition of "buyer in ordinary course of business" (Section 1-201 (A.C.A. § 4-1-201)) is effective here and preserves the essence of the healthy limitations engrafted by the case-law on the older statutes. The older loose concept of good faith and wide definition of value combined to create apparent good faith purchasers in many situations in which the result outraged common sense; the court's solution was to protect the original title especially by use of "cash sale" or of overtechnical construction of the enabling clauses of the statutes. But such rulings then turned into limitations on the proper protection of buyers in the ordinary market. Section 1-201(9) (A.C.A. § 4-1-201(9)) cuts down the category of buyer in ordinary course in such fashion as to take care of the results of the cases, but with no price either in confusion or in injustice to proper dealings in the normal market.

4. Except as provided in subsection (1) (A.C.A. § 4-2-403(1)), the rights of purchasers other than buyers in ordinary course are left to the Articles (Chapters) on Secured Transactions, Documents of Title, and Bulk Sales.



*Cross References:*

Point 1: Sections 1-103 (A.C.A. § 4-1-103) and 1-201 (A.C.A. § 4-1-201).

Point 2: Sections 1-201 (A.C.A. § 4-1-201), 2-402 (A.C.A. § 4-2-402), 7-205 (A.C.A. § 4-7-205) and 9-307(1) (A.C.A. § 4-9-307(1)).

Points 3 and 4: Sections 1-102 (A.C.A. § 4-1-102), 1-201 (A.C.A. § 4-1-201), 2-104 (A.C.A. § 4-2-104), 2-707 (A.C.A. § 4-2-707) and Articles (Chapters) 6, 7 and 9.

*Definitional Cross References:*

"Buyer in ordinary course of business". Section 1-201 (A.C.A. § 4-1-201). "Good faith". Sections 1-201 (A.C.A. § 4-1-201) and 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1991, No. 344, § 3, to reflect the enactment of Article 4A (A.C.A. § 4-4A-101 et seq.) concerning bulk transfers.

**Comment to § 2-501 (A.C.A. § 4-2-501)**

*Prior Uniform Statutory Provision:* See Sections 17 and 19, Uniform Sales Act.

*Purposes:*

1. The present section deals with the manner of identifying goods to the contract so that an insurable interest in the buyer and the rights set forth in the next section will accrue. Generally speaking, identification may be made in any manner "explicitly agreed to" by the parties. The rules of paragraphs (1)(a) (A.C.A. § 4-2-501(1)(a)), (1)(b) (A.C.A. § 4-2-501(1)(b)) and (1)(c) (A.C.A. § 4-2-501(1)(c)) apply only in the absence of such "explicit agreement".

2. In the ordinary case identification of particular existing goods as goods to which the contract refers is unambiguous and may occur in one of many ways. It is possible, however, for the identification to be tentative or contingent. In view of the limited effect given to identification by this Article (Chapter), the general policy is to resolve all doubts in favor of identification.

3. The provision of this section as to "explicit agreement" clarifies the present confusion in the law of sales which has arisen from the fact that under prior uniform legislation all rules of presumption with reference to the passing of title or to appropriation (which in turn depended upon identification) were regarded as subject to the contrary intention of the parties or of the party appropriating. Such uncer-

tainty is reduced to a minimum under this section by requiring "explicit agreement" of the parties before the rules of paragraphs (1)(a) (A.C.A. § 4-2-501(1)(a)), (1)(b) (A.C.A. § 4-2-501(1)(b)) and (1)(c) (A.C.A. § 4-2-501(1)(c)) are displaced — as they would be by a term giving the buyer power to select the goods. An "explicit" agreement, however, need not necessarily be found in the terms used in the particular transaction. Thus, where a usage of the trade has previously been made explicit by reduction to a standard set of "rules and regulations" currently incorporated by reference into the contracts of the parties, a relevant provision of those "rules and regulations" is "explicit" within the meaning of this section.

4. In view of the limited function of identification there is no requirement in this section that the goods be in deliverable state or that all of the seller's duties with respect to the processing of the goods be completed in order that identification occur. For example, despite identification the risk of loss remains on the seller under the risk of loss provisions until completion of his duties as to the goods and all of his remedies remain dependent upon his not defaulting under the contract.

5. Undivided shares in an identified fungible bulk, such as grain in an elevator or oil in a storage tank, can be sold. The mere making of the contract with reference to an undivided share in an identified fungible bulk is enough under subsection

(1)(a) (A.C.A. § 4-2-501(1)(a)) to effect an identification if there is no explicit agreement otherwise. The seller's duty, however, to segregate and deliver according to the contract is not affected by such an identification but is controlled by other provisions of this Article (Chapter).

6. Identification of crops under paragraph (1)(c) (A.C.A. § 4-2-501(1)(c)) is made upon planting only if they are to be harvested within the year or within the next normal harvest season. The phrase "next normal harvest season" fairly includes nursery stock raised for normally quick "harvest," but plainly excludes a "timber" crop to which the concept of a harvest "season" is inapplicable.

Paragraph (1)(c) (A.C.A. § 4-2-501(1)(c)) is also applicable to a crop of wool or the young of animals to be born within twelve months after contracting. The product of a lumbering, mining or fishing operation, though seasonal, is not within the concept of "growing". Identification under a contract for all or part of the output of such an operation can be effected early in the operation.

*Cross References:*

Point 1: Section 2-502 (A.C.A. § 4-2-502).

Point 4: Sections 2-509 (A.C.A. § 4-2-509), 2-510 (A.C.A. § 4-2-510) and 2-703 (A.C.A. § 4-2-703).

Point 5: Sections 2-105 (A.C.A. § 4-2-105), 2-308 (A.C.A. § 4-2-308), 2-503 (A.C.A. § 4-2-503) and 2-509 (A.C.A. § 4-2-509).

Point 6: Sections 2-105(1) (A.C.A. § 4-2-105(1)), 2-107(1) (A.C.A. § 4-2-107(1)) and 2-402 (A.C.A. § 4-2-402).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Future goods". Section 2-105 (A.C.A. § 4-2-105).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-502 (A.C.A. § 4-2-502)**

*Prior Uniform Statutory Provision:* Compare Sections 17, 18 and 19, Uniform Sales Act.

*Purposes:*

1. This section gives an additional right to the buyer as a result of identification of the goods to the contract in the manner provided in Section 2-501 (A.C.A. § 4-2-501). The buyer is given a right to the goods on the seller's insolvency occurring within 10 days after he receives the first installment on their price.

2. The question of whether the buyer also acquires a security interest in identified goods and has rights to the goods when insolvency takes place after the ten-day period provided in this section depends upon compliance with the provisions of the Article (Chapter) on Secured Transactions (Article 9 (Chapter 9)).

3. Subsection (2) (A.C.A. § 4-2-502(2)) is included to preclude the possibility of unjust enrichment which exists if the

buyer were permitted to recover goods even though they were greatly superior in quality or quantity to that called for by the contract for sale.

*Cross References:*

Point 1: Sections 1-201 (A.C.A. § 4-1-201) and 2-702 (A.C.A. § 4-2-702).

Point 2: Article 9 (Chapter 9).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Insolvent". Section 1-201 (A.C.A. § 4-1-201).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).



### Comment to § 2-503 (A.C.A. § 4-2-503)

*Prior Uniform Statutory Provision:* See Sections 11, 19, 20, 43(3) and (4), 46 and 51, Uniform Sales Act.

*Changes:* The general policy of the above sections is continued and supplemented but subsection (3) (A.C.A. § 4-2-503(3)) changes the rule of prior section 19(5) as to what constitutes a "destination" contract and subsection (4) (A.C.A. § 4-2-503(4)) incorporates a minor correction as to tender of delivery of goods in the possession of a bailee.

*Purposes of Changes:*

1. The major general rules governing the manner of proper or due tender of delivery are gathered in this section. The term "tender" is used in this Article (Chapter) in two different senses. In one sense it refers to "due tender" which contemplates an offer coupled with a present ability to fulfill all the conditions resting on the tendering party and must be followed by actual performance if the other party shows himself ready to proceed. Unless the context unmistakably indicates otherwise this is the meaning of "tender" in this Article (Chapter) and the occasional addition of the word "due" is only for clarity and emphasis. At other times it is used to refer to an offer of goods or documents under a contract as if in fulfillment of its conditions even though there is a defect when measured against the contract obligation. Used in either sense, however, "tender" connotes such performance by the tendering party as puts the other party in default if he fails to proceed in some manner.

2. The seller's general duty to tender and deliver is laid down in Section 2-301 (A.C.A. § 4-2-301) and more particularly in Section 2-507 (A.C.A. § 4-2-507). The seller's right to a receipt if he demands one and receipts are customary is governed by Section 1-205 (A.C.A. § 4-1-205). Subsection (1) (A.C.A. § 4-2-503(1)) of the present section proceeds to set forth two primary requirements of tender: first, that the seller "put and hold conforming goods at the buyer's disposition" and, second, that he "give the buyer any notice reasonably necessary to enable him to take delivery."

In cases in which payment is due and

demanded upon delivery the "buyer's disposition" is qualified by the seller's right to retain control of the goods until payment by the provision of this Article (Chapter) on delivery on condition. However, where the seller is demanding payment on delivery he must first allow the buyer to inspect the goods in order to avoid impairing his tender unless the contract for sale is on C.I.F., C.O.D., cash against documents or similar terms negating the privilege of inspection before payment.

In the case of contracts involving documents the seller can "put and hold conforming goods at the buyer's disposition" under subsection (1) (A.C.A. § 4-2-503(1)) by tendering documents which give the buyer complete control of the goods under the provisions of Article 7 (Chapter 7) on due negotiation.

3. Under paragraph (a) of subsection (1) (A.C.A. § 4-2-503(1)(a)) usage of the trade and the circumstances of the particular case determine what is a reasonable hour for tender and what constitutes a reasonable period of holding the goods available.

4. The buyer must furnish reasonable facilities for the receipt of the goods tendered by the seller under subsection (1), paragraph (b) (A.C.A. § 4-2-503(1)(b)). This obligation of the buyer is no part of the seller's tender.

5. For the purposes of subsections (2) and (3) (A.C.A. § 4-2-503(2) and (3)) there is omitted from this Article (Chapter) the rule under prior uniform legislation that a term requiring the seller to pay the freight or cost of transportation to the buyer is equivalent to an agreement by the seller to deliver to the buyer or at an agreed destination. This omission is with the specific intention of negating the rule, for under this Article (Chapter) the "shipment" contract is regarded as the normal one and the "destination" contract as the variant type. The seller is not obligated to deliver at a named destination and bear the concurrent risk of loss until arrival, unless he has specifically agreed so to deliver or the commercial understanding of the terms used by the parties contemplates such delivery.

6. Paragraph (a) of subsection (4)



(A.C.A. § 4-2-503(4)(a)) continues the rule of the prior uniform legislation as to acknowledgment by the bailee. Paragraph (b) of subsection (4) (A.C.A. § 4-2-503(4)(b)) adopts the rule that between the buyer and the seller the risk of loss remains on the seller during a period reasonable for securing acknowledgment of the transfer from the bailee, while as against all other parties the buyer's rights are fixed as of the time the bailee receives notice of the transfer.

7. Under subsection (5) (A.C.A. § 4-2-503(5)) documents are never "required" except where there is an express contract term or it is plainly implicit in the peculiar circumstances of the case or in a usage of trade. Documents may, of course, be "authorized" although not required, but such cases are not within the scope of this subsection. When documents are required, there are three main requirements of this subsection: (1) "All": each required document is essential to a proper tender; (2) "Such": the documents must be the ones actually required by the contract in terms of source and substance; (3) "Correct form": all documents must be in correct form.

When a prescribed document cannot be procured, a question of fact arises under the provision of this Article (Chapter) on substituted performance as to whether the agreed manner of delivery is actually commercially impracticable and whether the substitute is commercially reasonable.

#### *Cross References:*

Point 2: Sections 1-205 (A.C.A. § 4-1-205), 2-301 (A.C.A. § 4-2-301), 2-310 (A.C.A. § 4-2-310), 2-507 (A.C.A. § 4-2-507) and 2-513 (A.C.A. § 4-2-513) and Article 7 (Chapter 7).

Point 5: Sections 2-308 (A.C.A. § 4-2-308), 2-310 (A.C.A. § 4-2-310) and 2-509 (A.C.A. § 4-2-509).

Point 7: Section 2-614(1) (A.C.A. § 4-2-614(1)).

Specific matters involving tender are covered in many additional sections of this Article (Chapter). See Sections 1-205 (A.C.A. § 4-1-205), 2-301 (A.C.A. § 4-2-301), 2-306 to 2-319 (A.C.A. §§ 4-2-306 to 4-2-319), 2-321(3) (A.C.A. § 4-2-321(3)), 2-504 (A.C.A. § 4-2-504), 2-507(2) (A.C.A. § 4-2-507(2)), 2-511(1) (A.C.A. § 4-2-511(1)), 2-513 (A.C.A. § 4-2-513), 2-612 (A.C.A. § 4-2-612) and 2-614 (A.C.A. § 4-2-614).

#### *Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conforming". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Dishonor". Section 3-508 (A.C.A. § 4-3-508).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Written". Section 1-201 (A.C.A. § 4-1-201).

#### **Comment to § 2-504 (A.C.A. § 4-2-504)**

*Prior Uniform Statutory Provision:* Section 46, Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:* To continue the general policy of the prior uniform statutory provision while incorporating certain

modifications with respect to the requirement that the contract with the carrier be made expressly on behalf of the buyer and as to the necessity of giving notice of the shipment to the buyer, so that:

1. The section is limited to "shipment" contracts as contrasted with "destination"

contracts or contracts for delivery at the place where the goods are located. The general principles embodied in this section cover the special cases of F.O.B. point of shipment contracts and C.I.F. and C. & F. contracts. Under the preceding section on manner of tender of delivery, due tender by the seller requires that he comply with the requirements of this section in appropriate cases.

2. The contract to be made with the carrier under paragraph (a) (A.C.A. § 4-2-504(a)) must conform to all express terms of the agreement, subject to any substitution necessary because of failure of agreed facilities as provided in the later provision on substituted performance. However, under the policies of this Article (Chapter) on good faith and commercial standards and on buyer's rights on improper delivery, the requirements of explicit provisions must be read in terms of their commercial and not their literal meaning. This policy is made express with respect to bills of lading in a set in the provision of this Article (Chapter) on form of bills of lading required in overseas shipment.

3. In the absence of agreement, the provision of this Article (Chapter) on options and cooperation respecting performance gives the seller the choice of any reasonable carrier, routing and other arrangements. Whether or not the shipment is at the buyer's expense the seller must see to any arrangements, reasonable in the circumstances, such as refrigeration, watering of livestock, protection against cold, the sending along of any necessary help, selection of specialized cars and the like for paragraph (a) (A.C.A. § 4-2-504(a)) is intended to cover all necessary arrangements whether made by contract with the carrier or otherwise. There is, however, a proper relaxation of such requirements if the buyer is himself in a position to make the appropriate arrangements and the seller gives him reasonable notice of the need to do so. It is an improper contract under paragraph (a) (A.C.A. § 4-2-504(a)) for the seller to agree with the carrier to a limited valuation below the true value and thus cut off the buyer's opportunity to recover from the carrier in the event of loss, when the risk of shipment is placed on the buyer by his contract with the seller.

4. Both the language of paragraph (b)

(A.C.A. § 4-2-504(b)) and the nature of the situation it concerns indicate that the requirement that the seller must obtain and deliver promptly to the buyer in due form any document necessary to enable him to obtain possession of the goods is intended to cumulate with the other duties of the seller such as those covered in paragraph (a) (A.C.A. § 4-2-504(a)).

In this connection, in the case of pool car shipments a delivery order furnished by the seller on the pool car consignee, or on the carrier for delivery out of a larger quantity, satisfies the requirements of paragraph (b) (A.C.A. § 4-2-504(b)) unless the contract requires some other form of document.

5. This Article (Chapter), unlike the prior uniform statutory provision, makes it the seller's duty to notify the buyer of shipment in all cases. The consequences of his failure to do so, however, are limited in that the buyer may reject on this ground only where material delay or loss ensues.

A standard and acceptable manner of notification in open credit shipments is the sending of an invoice and in the case of documentary contracts is the prompt forwarding of the documents as under paragraph (b) (A.C.A. § 4-2-504(b)) of this section. It is also usual to send on a straight bill of lading but this is not necessary to the required notification. However, should such a document prove necessary or convenient to the buyer, as in the case of loss and claim against the carrier, good faith would require the seller to send it on request.

Frequently the agreement expressly requires prompt notification as by wire or cable. Such a term may be of the essence and the final clause of paragraph (c) (A.C.A. § 4-2-504(c)) does not prevent the parties from making this a particular ground for rejection. To have this vital and irreparable effect upon the seller's duties, such a term should be part of the "dictated" terms written in any "form," or should otherwise be called seasonably and sharply to the seller's attention.

6. Generally, under the final sentence of the section, rejection by the buyer is justified only when the seller's dereliction as to any of the requirements of this section in fact is followed by material delay or damage. It rests on the seller, so far as concerns matters not within the peculiar knowledge of the buyer, to estab-



lish that his error has not been followed by events which justify rejection.

*Cross References:*

Point 1: Sections 2-319 (A.C.A. § 4-2-319), 2-320 (A.C.A. § 4-2-320) and 2-503(2) (A.C.A. § 4-2-503(2)).

Point 2: Sections 1-203 (A.C.A. § 4-1-203), 2-323(2) (A.C.A. § 4-2-323(2)), 2-601 (A.C.A. § 4-2-601) and 2-614(1) (A.C.A. § 4-2-614(1)).

Point 3: Section 2-311(2) (A.C.A. § 4-2-311(2)).

Point 5: Section 1-203 (A.C.A. § 4-1-203).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Usage of trade". Section 1-205 (A.C.A. § 4-1-205).

**Comment to § 2-505 (A.C.A. § 4-2-505)**

*Prior Uniform Statutory Provision:* Section 20(2), (3), (4), Uniform Sales Act.

*Changes:* Completely rephrased, the "powers" of the parties in cases of reservation being emphasized primarily rather than the "rightfulness" of reservation.

*Purposes of Changes:* To continue in general the policy of the prior uniform statutory provision with certain modifications of emphasis and language, so that:

1. The security interest reserved to the seller under subsection (1) (A.C.A. § 4-2-505(1)) is restricted to securing payment or performance by the buyer and the seller is strictly limited in his disposition and control of the goods as against the buyer and third parties. Under this Article (Chapter), the provision as to the passing of interest expressly applies "despite any reservation of security title" and also provides that the "rights, obligations and remedies" of the parties are not altered by the incidence of title generally. The security interest, therefore, must be regarded as a means given to the seller to enforce his rights against the buyer which is unaffected by and in turn does not affect the location of title generally. The rules set forth in subsection (1) (A.C.A. § 4-2-505(1)) are not to be altered by any apparent "contrary intent" of the parties as to passing of title, since the rights and remedies of the parties to the contract of sale, as defined in this Article (Chapter), rest on the contract and its performance or

breach and not on stereotyped presumptions as to the location of title.

This Article (Chapter) does not attempt to regulate local procedure in regard to the effective maintenance of the seller's security interest when the action is in replevin by the buyer against the carrier.

2. Every shipment of identified goods under a negotiable bill of lading reserves a security interest in the seller under subsection (1) paragraph (a) (A.C.A. § 4-2-505(1)(a)).

It is frequently convenient for the seller to make the bill of lading to the order of a nominee such as his agent at destination, the financing agency to which he expects to negotiate the document or the bank issuing a credit to him. In many instances, also, the buyer is made the order party. This Article (Chapter) does not deal directly with the question as to whether a bill of lading made out by the seller to the order of a nominee gives the carrier notice of any rights which the nominee may have so as to limit its freedom or obligation to honor the bill of lading in the hands of the seller as the original shipper if the expected negotiation fails. This is dealt with in the Article (Chapter) on Documents of Title (Article 7 (Chapter 7)).

3. A non-negotiable bill of lading taken to a party other than the buyer under subsection (1) paragraph (b) (A.C.A. § 4-2-505(1)(b)) reserves possession of the goods as security in the seller but if he seeks to withhold the goods improperly



the buyer can tender payment and recover them.

4. In the case of a shipment by non-negotiable bill of lading taken to a buyer, the seller, under subsection (1) (A.C.A. § 4-2-505(1)) retains no security interest or possession as against the buyer and by the shipment he de facto loses control as against the carrier except where he rightfully and effectively stops delivery in transit. In cases in which the contract gives the seller the right to payment against delivery, the seller, by making an immediate demand for payment, can show that his delivery is conditional, but this does not prevent the buyer's power to transfer full title to a sub-buyer in ordinary course or other purchaser under Section 2-403 (A.C.A. § 4-2-403).

5. Under subsection (2) (A.C.A. § 4-2-505(2)) an improper reservation by the seller which would constitute a breach in no way impairs such of the buyer's rights as result from identification of the goods. The security title reserved by the seller under subsection (1) (A.C.A. § 4-2-505(1)) does not protect his holding of the document or the goods for the purpose of exacting more than is due him under the contract.

*Cross References:*

Point 1: Section 1-201 (A.C.A. § 4-1-201).

Point 2: Article 7 (Chapter 7).

Point 3: Sections 2-501(2) (A.C.A. § 4-2-501(2)) and 2-504 (A.C.A. § 4-2-504).

Point 4: Sections 2-403 (A.C.A. § 4-2-403), 2-507(2) (A.C.A. § 4-2-507(2)) and 2-705 (A.C.A. § 4-2-705).

Point 5: Sections 2-310 (A.C.A. § 4-2-310), 2-319(4) (A.C.A. § 4-2-319(4)), 2-320(4) (A.C.A. § 4-2-320(4)), 2-501 (A.C.A. § 4-2-501) and 2-502 (A.C.A. § 4-2-502) and Article 7 (Chapter 7).

*Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Consignee". Section 7-102 (A.C.A. § 4-7-102).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Financing agency". Section 2-104 (A.C.A. § 4-2-104).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-506 (A.C.A. § 4-2-506)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. "Financing agency" is broadly defined in this Article (Chapter) to cover every normal instance in which a party aids or intervenes in the financing of a sales transaction. The term as used in subsection (1) (A.C.A. § 4-2-506(1)) is not in any sense intended as a limitation and covers any other appropriate situation which may arise outside the scope of the definition.

2. "Paying" as used in subsection (1) (A.C.A. § 4-2-506(1)) is typified by the letter credit, or "authority to pay" situation in which a banker, by arrangement with the buyer or other consignee, pays on his behalf a draft for the price of the goods. It is immaterial whether the draft is for-

mally drawn on the party paying or his principal, whether it is a sight draft paid in cash or a time draft "paid" in the first instance by acceptance, or whether the payment is viewed as absolute or conditional. All of these cases constitute "payment" under this subsection. Similarly, "purchasing for value" is used to indicate the whole area of financing by the seller's banker, and the principle of subsection (1) (A.C.A. § 4-2-506(1)) is applicable without any niceties of distinction between "purchase," "discount," "advance against collection" or the like. But it is important to notice that the only right to have the draft honored that is acquired is that against the buyer; if any right against anyone else is claimed it will have to be under some separate obligation of that other person. A letter of credit does not

necessarily protect purchasers of drafts. See Article 5 (Chapter 5). And for the relations of the parties to documentary drafts see Part 5 of Article 4 (Chapter 4).

3. Subsection (1) (A.C.A. § 4-2-506(1)) is made applicable to payments or advances against a draft which "relates to" a shipment of goods and this has been chosen as a term of maximum breadth. In particular the term is intended to cover the case of a draft against an invoice or against a delivery order. Further, it is unnecessary that there be an explicit assignment of the invoice attached to the draft to bring the transaction within the reason of this subsection.

4. After shipment, "the rights of the shipper in the goods" are merely security rights and are subject to the buyer's right to force delivery upon tender of the price. The rights acquired by the financing agency are similarly limited and, moreover, if the agency fails to procure any outstanding negotiable document of title, it may find its exercise of these rights hampered or even defeated by the seller's disposition of the document to a third party. This section does not attempt to create any new rights in the financing agency against the carrier which would force the latter to honor a stop order from the agency, a stranger to the shipment, or any new rights against a holder to whom a

document of title has been duly negotiated under Article 7 (Chapter 7).

#### *Cross References:*

Point 1: Section 2-104(2) (A.C.A. § 4-2-104(2)) and Article 4 (Chapter 4).

Point 2: Part 5 of Article 4 (Chapter 4) and Article 5 (Chapter 5).

Point 4: Sections 2-501 (A.C.A. § 4-2-501) and 2-502(1) (A.C.A. § 4-2-502(1)) and Article 7 (Chapter 7).

#### *Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Financing agency". Section 2-104 (A.C.A. § 4-2-104).

"Good faith". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

### **Comment to § 2-507 (A.C.A. § 4-2-507)**

*Prior Uniform Statutory Provision:* See Sections 11, 41, 42 and 69, Uniform Sales Act.

#### *Purposes:*

1. Subsection (1) (A.C.A. § 4-2-507(1)) continues the policies of the prior uniform statutory provisions with respect to tender and delivery by the seller. Under this Article (Chapter) the same rules in these matters are applied to present sales and to contracts for sale. But the provisions of this subsection must be read within the framework of the other sections of this Article (Chapter) which bear upon the question of delivery and payment.

2. The "unless otherwise agreed" provision of subsection (1) (A.C.A. § 4-2-507(1)) is directed primarily to cases in which payment in advance has been promised or a letter of credit term has been included. Payment "according to the contract" con-

templates immediate payment, payment at the end of an agreed credit term, payment by a time acceptance or the like. Under this Act, "contract" means the total obligation in law which results from the parties' agreement including the effect of this Article (Chapter). In this context, therefore, there must be considered the effect in law of such provisions as those on means and manner of payment and on failure of agreed means and manner of payment.

3. Subsection (2) (A.C.A. § 4-2-507(2)) deals with the effect of a conditional delivery by the seller and in such a situation makes the buyer's "right as against the seller" conditional upon payment. These words are used as words of limitation to conform with the policy set forth in the bona fide purchase sections of this Article (Chapter). Should the seller after making such a conditional delivery fail to follow



up his rights, the condition is waived. This subsection (2) (A.C.A. § 4-2-507(2)) codifies the cash seller's right of reclamation which is in the nature of a lien. There is no specific time limit for a cash seller to exercise the right of reclamation. However, the right will be defeated by delay causing prejudice to the buyer, waiver, estoppel, or ratification of the buyer's right to retain possession. Common law rules and precedents governing such principles are applicable (Section 1-103) (A.C.A. § 4-1-103). If third parties are involved, Section 2-403(1) (A.C.A. § 4-2-403(1)) protects good faith purchasers. See PEB Commentary No. 1, dated March 10, 1990.

*Cross References:*

Point 1: Sections 2-310 (A.C.A. § 4-3-210), 2-503 (A.C.A. § 4-2-503), 2-511 (A.C.A. § 4-2-511), 2-601 (A.C.A. § 4-2-601) and 2-711 to 2-713 (A.C.A. §§ 4-2-711 — 4-2-713).

Point 2: Sections 1-201 (A.C.A. § 4-1-

201), 2-511 (A.C.A. § 4-2-511) and 2-614 (A.C.A. § 4-2-614).

Point 3: Sections 2-401 (A.C.A. § 4-2-401), 2-403 (A.C.A. § 4-2-403) and 2-702(1)(b).\*

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

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\*There is no section 2-702(1)(b) in the Uniform Commercial Code.

**Comment to § 2-508 (A.C.A. § 4-2-508)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-2-508(1)) permits a seller who has made a non-conforming tender in any case to make a conforming delivery within the contract time upon seasonable notification to the buyer. It applies even where the seller has taken back the non-conforming goods and refunded the purchase price. He may still make a good tender within the contract period. The closer, however, it is to the contract date, the greater is the necessity for extreme promptness on the seller's part in notifying of his intention to cure, if such notification is to be "seasonable" under this subsection.

The rule of this subsection, moreover, is qualified by its underlying reasons. Thus if, after contracting for June delivery, a buyer later makes known to the seller his need for shipment early in the month and the seller ships accordingly, the "contract time" has been cut down by the supervening modification and the time for cure of tender must be referred to this modified time term.

2. Subsection (2) (A.C.A. § 4-2-508(2)) seeks to avoid injustice to the seller by

reason of a surprise rejection by the buyer. However, the seller is not protected unless he had "reasonable grounds to believe" that the tender would be acceptable. Such reasonable grounds can lie in prior course of dealing, course of performance or usage of trade as well as in the particular circumstances surrounding the making of the contract. The seller is charged with commercial knowledge of any factors in a particular sales situation which require him to comply strictly with his obligations under the contract as, for example, strict conformity of documents in an overseas shipment or the sale of precision parts or chemicals for use in manufacture. Further, if the buyer gives notice either implicitly, as by a prior course of dealing involving rigorous inspections, or expressly, as by the deliberate inclusion of a "no replacement" clause in the contract, the seller is to be held to rigid compliance. If the clause appears in a "form" contract evidence that it is out of line with trade usage or the prior course of dealing and was not called to the seller's attention may be sufficient to show that the seller had reasonable grounds to believe that the tender would be acceptable.

3. The words "a further reasonable

time to substitute a conforming tender" are intended as words of limitation to protect the buyer. What is a "reasonable time" depends upon the attending circumstances. Compare Section 2-511 (A.C.A. § 4-2-511) on the comparable case of a seller's surprise demand for legal tender.

4. Existing trade usages permitting variations without rejection but with price allowance enter into the agreement itself as contractual limitations of remedy and are not covered by this section.

*Cross References:*

Point 2: Section 2-302 (A.C.A. § 4-2-302).

Point 3: Section 2-511 (A.C.A. § 4-2-511).

Point 4: Sections 1-205 (A.C.A. § 4-1-205) and 2-721 (A.C.A. § 4-2-721).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conforming". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-509 (A.C.A. § 4-2-509)**

*Prior Uniform Statutory Provision:* Section 22, Uniform Sales Act.

*Changes:* Rewritten, subsection (3) of this section (A.C.A. § 4-2-509(3)) modifying prior law.

*Purposes of Changes:* To make it clear that:

1. The underlying theory of these sections on risk of loss is the adoption of the contractual approach rather than an arbitrary shifting of the risk with the "property" in the goods. The scope of the present section, therefore, is limited strictly to those cases where there has been no breach by the seller. Where for any reason his delivery or tender fails to conform to the contract, the present section does not apply and the situation is governed by the provisions on effect of breach on risk of loss.

2. The provisions of subsection (1) (A.C.A. § 4-2-509(1)) apply where the contract "requires or authorizes" shipment of the goods. This language is intended to be construed parallel to comparable language in the section on shipment by seller. In order that the goods be "duly delivered to the carrier" under paragraph (a) (A.C.A. § 4-2-509(1)(a)) a contract must be entered into with the carrier which will satisfy the requirements of the section on shipment by the seller and the delivery must be made under circumstances which will enable the seller to take any further

steps necessary to a due tender. The underlying reason of this subsection does not require that the shipment be made after contracting, but where, for example, the seller buys the goods afloat and later diverts the shipment to the buyer, he must identify the goods to the contract before the risk of loss can pass. To transfer the risk it is enough that a proper shipment and a proper identification come to apply to the same goods although, aside from special agreement, the risk will not pass retroactively to the time of shipment in such a case.

3. Whether the contract involves delivery at the seller's place of business or at the situs of the goods, a merchant seller cannot transfer risk of loss and it remains upon him until actual receipt by the buyer, even though full payment has been made and the buyer has been notified that the goods are at his disposal. Protection is afforded him, in the event of breach by the buyer, under the next section.

The underlying theory of this rule is that a merchant who is to make physical delivery at his own place continues meanwhile to control the goods and can be expected to insure his interest in them. The buyer, on the other hand, has no control of the goods and it is extremely unlikely that he will carry insurance on goods not yet in his possession.

4. Where the agreement provides for delivery of the goods as between the buyer



and seller without removal from the physical possession of a bailee, the provisions on manner of tender of delivery apply on the point of transfer of risk. Due delivery of a negotiable document of title covering the goods or acknowledgment by the bailee that he holds for the buyer completes the "delivery" and passes the risk.

5. The provisions of this section are made subject by subsection (4) (A.C.A. § 4-2-509(4)) to the "contrary agreement" of the parties. This language is intended as the equivalent of the phrase "unless otherwise agreed" used more frequently throughout this Act. "Contrary" is in no way used as a word of limitation and the buyer and seller are left free to readjust their rights and risks as declared by this section in any manner agreeable to them. Contrary agreement can also be found in the circumstances of the case, a trade usage or practice, or a course of dealing or performance.

*Cross References:*

Point 1: Section 2-510(1) (A.C.A. § 4-2-510(1)).

Point 2: Sections 2-503 (A.C.A. § 4-2-503) and 2-504 (A.C.A. § 4-2-504).

Point 3: Sections 2-104 (A.C.A. § 4-2-

104), 2-503 (A.C.A. § 4-2-503) and 2-510 (A.C.A. § 4-2-510).

Point 4: Section 2-503(4) (A.C.A. § 4-2-503(4)).

Point 5: Section 1-201 (A.C.A. § 4-1-201).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Merchant". Section 2-104 (A.C.A. § 4-2-104).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Sale on approval". Section 2-326 (A.C.A. § 4-2-326).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-510 (A.C.A. § 4-2-510)**

*Prior Uniform Statutory Provision:* None.

*Purposes:* To make it clear that:

1. Under subsection (1) (A.C.A. § 4-2-510(1)) the seller by his individual action cannot shift the risk of loss to the buyer unless his action conforms with all the conditions resting on him under the contract.

2. The "cure" of defective tenders contemplated by subsection (1) (A.C.A. § 4-2-510(1)) applies only to those situations in which the seller makes changes in goods already tendered, such as repair, partial substitution, sorting out from an improper mixture and the like since "cure" by repossession and new tender has no effect on the risk of loss of the goods originally tendered. The seller's privilege of cure does not shift the risk, however, until the cure is completed.

Where defective documents are involved, a cure of the defect by the seller or a waiver of the defects by the buyer will operate to shift the risk under this section.

However, if the goods have been destroyed prior to the cure or the buyer is unaware of their destruction at the time he waives the defect in the documents, the risk of the loss must still be borne by the seller, for the risk shifts only at the time of cure, waiver of documentary defects or acceptance of the goods.

3. In cases where there has been a breach of the contract, if the one in control of the goods is the aggrieved party, whatever loss or damage may prove to be uncovered by his insurance falls upon the contract breaker under subsections (2) (A.C.A. § 4-2-510(2)) and (3) (A.C.A. § 4-2-510(3)) rather than upon him. The word "effective" as applied to insurance coverage in those subsections is used to meet the case of supervening insolvency of the insurer. The "deficiency" referred to in the text means such deficiency in the insurance coverage as exists without subrogation. This section merely distributes the risk of loss as stated and is not intended to

be disturbed by any subrogation of an insurer.

*Cross Reference:*

Section 2-509 (A.C.A. § 4-2-509).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-511 (A.C.A. § 4-2-511)**

*Prior Uniform Statutory Provision:* Section 42, Uniform Sales Act.

*Changes:* Rewritten by this section and Section 2-507 (A.C.A. § 4-2-507).

*Purposes of Changes:*

1. The requirement of payment against delivery in subsection (1) (A.C.A. § 4-2-511(1)) is applicable to noncommercial sales generally and to ordinary sales at retail although it has no application to the great body of commercial contracts which carry credit terms. Subsection (1) (A.C.A. § 4-2-511(1)) applies also to documentary contracts in general and to contracts which look to shipment by the seller but contain no term on time and manner of payment, in which situations the payment may, in proper case, be demanded against delivery of appropriate documents.

In the case of specific transactions such as C.O.D. sales or agreements providing for payment against documents, the provisions of this subsection must be considered in conjunction with the special sections of the Article (Chapter) dealing with such terms. The provision that tender of payment is a condition to the seller's duty to tender and complete "any delivery" integrates this section with the language and policy of the section on delivery in several lots which call for separate payment. Finally, attention should be directed to the provision on right to adequate assurance of performance which recognizes, even before the time for tender, an obligation on the buyer not to impair the seller's expectation of receiving payment in due course.

2. Unless there is agreement otherwise the concurrence of the conditions as to tender of payment and tender of delivery requires their performance at a single place or time. This Article (Chapter) determines that place and time by determining in various other sections the place and

time for tender of delivery under various circumstances and in particular types of transactions. The sections dealing with time and place of delivery together with the section on right to inspection of goods answer the subsidiary question as to when payment may be demanded before inspection by the buyer.

3. The essence of the principle involved in subsection (2) (A.C.A. § 4-2-511(2)) is avoidance of commercial surprise at the time of performance. The section on substituted performance covers the peculiar case in which legal tender is not available to the commercial community.

4. Subsection (3) (A.C.A. § 4-2-511(3)) is concerned with the rights and obligations as between the parties to a sales transaction when payment is made by check. This Article (Chapter) recognizes that the taking of a seemingly solvent party's check is commercially normal and proper and, if due diligence is exercised in collection, is not to be penalized in any way. The conditional character of the payment under this section refers only to the effect of the transaction "as between the parties" thereto and does not purport to cut into the law of "absolute" and "conditional" payment as applied to such other problems as the discharge of sureties or the responsibilities of a drawee bank which is at the same time an agent for collection.

The phrase "by check" includes not only the buyer's own but any check which does not effect a discharge under Article 3 (Chapter 3) (Section 3-802 (A.C.A. § 4-3-802)). Similarly the reason of this subsection should apply and the same result should be reached where the buyer "pays" by sight draft on a commercial firm which is financing him.

5. Under subsection (3) (A.C.A. § 4-2-511(3)) payment by check is defeated if it is not honored upon due presentment.



This corresponds to the provisions of Article (Chapter) on Commercial Paper. (Section 3-802 (A.C.A. § 4-3-802)). But if the seller procures certification of the check instead of cashing it, the buyer is discharged. (Section 3-411 (A.C.A. § 4-3-411)).

6. Where the instrument offered by the buyer is not a payment but a credit instrument such as a note or a check postdated by even one day, the seller's acceptance of the instrument insofar as third parties are concerned, amounts to a delivery on credit and his remedies are set forth in the section on buyer's insolvency. As between the buyer and the seller, however, the matter turns on the present subsection and the section on conditional delivery and subsequent dishonor of the instrument gives the seller rights on it as well as for breach of the contract for sale.

#### *Cross References:*

Point 1: Sections 2-307 (A.C.A. § 4-2-307), 2-310 (A.C.A. § 4-2-310), 2-320 (A.C.A. § 4-2-320), 2-325 (A.C.A. § 4-2-325), 2-503 (A.C.A. § 4-2-503), 2-513 (A.C.A. § 4-2-513) and 2-609 (A.C.A. § 4-2-609).

Point 2: Sections 2-307 (A.C.A. § 4-2-307), 2-310 (A.C.A. § 4-2-310), 2-319 (A.C.A. § 4-2-319), 2-322 (A.C.A. § 4-2-322), 2-503 (A.C.A. § 4-2-503), 2-504 (A.C.A. § 4-2-504) and 2-513 (A.C.A. § 4-2-513).

Point 3: Section 2-614 (A.C.A. § 4-2-614).

Point 5: Article 3 (Chapter 3), esp. Sections 3-802 (A.C.A. § 4-3-802) and 3-411 (A.C.A. § 4-3-411).

Point 6: Sections 2-507 (A.C.A. § 4-2-507), 2-702 (A.C.A. § 4-2-702), and Article 3 (Chapter 3).

#### *Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Check". Section 3-104 (A.C.A. § 4-3-104).

"Dishonor". Section 3-508 (A.C.A. § 4-3-508).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### **Comment to § 2-512 (A.C.A. § 4-2-512)**

*Prior Uniform Statutory Provision:* None, but see Sections 47 and 49, Uniform Sales Act.

#### *Purposes:*

1. Subsection (1) (A.C.A. § 4-2-512(1)) of the present section recognizes that the essence of a contract providing for payment before inspection is the intention of the parties to shift to the buyer the risks which would usually rest upon the seller. The basic nature of the transaction is thus preserved and the buyer is in most cases required to pay first and litigate as to any defects later.

2. "Inspection" under this section is an inspection in a manner reasonable for detecting defects in goods whose surface appearance is satisfactory.

3. Clause (a) (A.C.A. § 4-2-512(1)(a)) of this subsection states an exception to the general rule based on common sense and normal commercial practice. The apparent non-conformity referred to is one which is evident in the mere process of taking delivery.

4. Clause (b) (A.C.A. § 4-2-512(1)(b)) is concerned with contracts for payment against documents and incorporates the general clarification and modification of the case law contained in the section on excuse of a financing agency. Section 5-114 (A.C.A. § 4-5-114).

5. Subsection (2) (A.C.A. § 4-2-512(2)) makes explicit the general policy of the Uniform Sales Act that the payment required before inspection in no way impairs the buyer's remedies or rights in the event of a default by the seller. The remedies preserved to the buyer are all of his remedies, which include as a matter of reason the remedy for total non-delivery after payment in advance.

The provision on performance or acceptance under reservation of rights does not apply to the situations contemplated here in which payment is made in due course under the contract and the buyer need not pay "under protest" or the like in order to preserve his rights as to defects discovered upon inspection.

6. This section applies to cases in which

the contract requires payment before inspection either by the express agreement of the parties or by reason of the effect in law of that contract. The present section must therefore be considered in conjunction with the provision on right to inspection of goods which sets forth the instances in which the buyer is not entitled to inspection before payment.

*Cross References:*

Point 4: Article 5 (Chapter 5).

Point 5: Section 1-207 (A.C.A. § 4-1-207).

Point 6: Section 2-513(3) (A.C.A. § 4-2-513(3)).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Financing agency". Section 2-104 (A.C.A. § 4-2-104).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-513 (A.C.A. § 4-2-513)**

*Prior Uniform Statutory Provision:* Section 47(2), (3), Uniform Sales Act.

*Changes:* Rewritten, Subsections (2) (A.C.A. § 4-2-513(2)) and (3) (A.C.A. § 4-2-513(3)) being new.

*Purposes of Changes and New Matter:* To correspond in substance with the prior uniform statutory provision and to incorporate in addition some of the results of the better case law so that:

1. The buyer is entitled to inspect goods as provided in subsection (1) (A.C.A. § 4-2-513(1)) unless it has been otherwise agreed by the parties. The phrase "unless otherwise agreed" is intended principally to cover such situations as those outlined in subsections (3) (A.C.A. § 4-2-513(3)) and (4) (A.C.A. § 4-2-513(4)) and those in which the agreement of the parties negates inspection before tender of delivery. However, no agreement by the parties can displace the entire right of inspection except where the contract is simply for the sale of "this thing." Even in a sale of boxed goods "as is" inspection is a right of the buyer, since if the boxes prove to contain some other merchandise altogether the price can be recovered back; nor do the limitations of the provision on effect of acceptance apply in such a case.

2. The buyer's right of inspection is available to him upon tender, delivery or appropriation of the goods with notice to him. Since inspection is available to him on tender, where payment is due against delivery he may, unless otherwise agreed, make his inspection before payment of the

price. It is also available to him after receipt of the goods and so may be postponed after receipt for a reasonable time. Failure to inspect before payment does not impair the right to inspect after receipt of the goods unless a case falls within subsection (4) (A.C.A. § 4-2-513(4)) on agreed and exclusive inspection provisions. The right to inspect goods which have been appropriated with notice to the buyer holds whether or not the sale was by sample.

3. The buyer may exercise his right of inspection at any reasonable time or place and in any reasonable manner. It is not necessary that he select the most appropriate time, place or manner to inspect or that his selection be the customary one in the trade or locality. Any reasonable time, place or manner is available to him and the reasonableness will be determined by trade usages, past practices between the parties and the other circumstances of the case.

The last sentence of subsection (1) (A.C.A. § 4-2-513(1)) makes it clear that the place of arrival of shipped goods is a reasonable place for their inspection.

4. Expenses of an inspection made to satisfy the buyer of the seller's performance must be assumed by the buyer in the first instance. Since the rule provides merely for an allocation of expense there is no policy to prevent the parties from providing otherwise in the agreement. Where the buyer would normally bear the expenses of the inspection but the goods are rightly rejected because of what the inspection reveals, demonstrable and rea-



sonable costs of the inspection are part of his incidental damage caused by the seller's breach.

5. In the case of payment against documents, subsection (3) (A.C.A. § 4-2-513(3)) requires payment before inspection, since shipping documents against which payment is to be made will commonly arrive and be tendered while the goods are still in transit. This Article (Chapter) recognizes no exception in any peculiar case in which the goods happen to arrive before the documents. However, where by the agreement payment is to await the arrival of the goods, inspection before payment becomes proper since the goods are then "available for inspection."

Where by the agreement the documents are to be held until arrival the buyer is entitled to inspect before payment since the goods are then "available for inspection". Proof of usage is not necessary to establish this right, but if inspection before payment is disputed the contrary must be established by usage or by an explicit contract term to that effect.

For the same reason, that the goods are available for inspection, a term calling payment against storage documents or a delivery order does not normally bar the buyer's right to inspection before payment under subsection (3)(b) (A.C.A. § 4-2-513(3)(b)). This result is reinforced by the buyer's right under subsection (1) (A.C.A. § 4-2-513(1)) to inspect goods which have been appropriated with notice to him.

6. Under subsection (4) (A.C.A. § 4-2-513(4)) an agreed place or method of inspection is generally held to be intended as exclusive. However, where compliance with such an agreed inspection term becomes impossible, the question is basically one of intention. If the parties clearly intend that the method of inspection named is to be a necessary condition without which the entire deal is to fail, the contract is at an end if that method becomes impossible. On the other hand, if the parties merely seek to indicate a convenient and reliable method but do not intend to give up the deal in the event of its failure, any reasonable method of inspection may be substituted under this Article (Chapter).

Since the purpose of an agreed place of inspection is only to make sure at that point whether or not the goods will be thrown back, the "exclusive" feature of the

named place is satisfied under this Article (Chapter) if the buyer's failure to inspect there is held to be an acceptance with the knowledge of such defects as inspection would have revealed within the section on waiver of buyer's objections by failure to particularize. Revocation of the acceptance is limited to the situations stated in the section pertaining to that subject. The reasonable time within which to give notice of defects within the section on notice of breach begins to run from the point of the "acceptance."

7. Clauses on time of inspection are commonly clauses which limit the time in which the buyer must inspect and give notice of defects. Such clauses are therefore governed by the section of this Article (Chapter) which requires that such a time limitation must be reasonable.

8. Inspection under this Article (Chapter) is not to be regarded as a "condition precedent to the passing of title" so that risk until inspection remains on the seller. Under subsection (4) (A.C.A. § 4-2-513(4)) such an approach cannot be sustained. Issues between the buyer and seller are settled in this Article (Chapter) almost wholly by special provisions and not by the technical determination of the locus of the title. Thus "inspection as a condition to the passing of title" becomes a concept almost without meaning. However, in peculiar circumstances inspection may still have some of the consequences hitherto sought and obtained under that concept.

9. "Inspection" under this section has to do with the buyer's check-up on whether the seller's performance is in accordance with a contract previously made and is not to be confused with the "examination" of the goods or of a sample or model of them at the time of contracting which may affect the warranties involved in the contract.

#### *Cross References:*

Generally: Sections 2-310(b) (A.C.A. § 4-2-310(b)), 2-321(3) (A.C.A. § 4-2-321(3)) and 2-606(1)(b) (A.C.A. § 4-2-606(1)(b)).

Point 1: Section 2-607 (A.C.A. § 4-2-607).

Point 2: Sections 2-501 (A.C.A. § 4-2-501) and 2-502 (A.C.A. § 4-2-502).

Point 4: Section 2-715 (A.C.A. § 4-2-715).

Point 5: Section 2-321(3) (A.C.A. § 4-2-321(3)).

Point 6: Sections 2-606 to 2-608 (A.C.A. §§ 4-2-606 to 4-2-608).

Point 7: Section 1-204 (A.C.A. § 4-1-204).

Point 8: Comment to Section 2-401 (A.C.A. § 4-2-401).

Point 9: Section 2-316(3)(b).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Presumed". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-514 (A.C.A. § 4-2-514)**

*Prior Uniform Statutory Provision:* Section 41, Uniform Bills of Lading Act.

*Changes:* Rewritten.

*Purposes of Changes:* To make the provision one of general application so that:

1. It covers any document against which a draft may be drawn, whatever may be the form of the document, and applies to interpret the action of a seller or consigner insofar as it may affect the rights and duties of any buyer, consignee or financing agency concerned with the paper. Supplementary or corresponding provisions are found in Sections 4-503 (A.C.A. § 4-4-503) and 5-112 (A.C.A. § 4-5-112).

2. An "arrival" draft is a sight draft within the purpose of this section.

*Cross References:*

Point 1: See Sections 2-502 (A.C.A. § 4-2-502), 2-505(2) (A.C.A. § 4-2-505(2)), 2-507(2) (A.C.A. § 4-2-507(2)), 2-512 (A.C.A. § 4-2-512), 2-513 (A.C.A. § 4-2-513), 2-607 (A.C.A. § 4-2-607) concerning protection of rights of buyer and seller, and 4-503 (A.C.A. § 4-4-503) and 5-112 (A.C.A. § 4-5-112) on delivery of documents.

*Definitional Cross References:*

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

**Comment to § 2-515 (A.C.A. § 4-2-515)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. To meet certain serious problems which arise when there is a dispute as to the quality of the goods and thereby perhaps to aid the parties in reaching a settlement, and to further the use of devices which will promote certainty as to the condition of the goods, or at least aid in preserving evidence of their condition.

2. Under paragraph (a) (A.C.A. § 4-2-515(a)), to afford either party an opportunity for preserving evidence, whether or

not agreement has been reached, and thereby to reduce uncertainty in any litigation and, in turn perhaps, to promote agreement.

Paragraph (a) (A.C.A. § 4-2-515(a)) does not conflict with the provisions on the seller's right to resell rejected goods or the buyer's similar right. Apparent conflict between these provisions which will be suggested in certain circumstances is to be resolved by requiring prompt action by the parties. Nor does paragraph (a) (A.C.A. § 4-2-515(a)) impair the effect of a



term for payment before inspection. Short of such defects as amount to fraud or substantial failure of consideration, non-conformity is neither an excuse nor a defense to an action for non-acceptance of documents. Normally, therefore, until the buyer has made payment, inspected and rejected the goods, there is no occasion or use for the rights under paragraph (a) (A.C.A. § 4-2-515(a)).

3. Under paragraph (b) (A.C.A. § 4-2-515(b)), to provide for third party inspection upon the agreement of the parties, thereby opening the door to amicable adjustments based upon the findings of such third parties.

The use of the phrase "conformity or condition" makes it clear that the parties' agreement may range from a complete settlement of all aspects of the dispute by a third party to the use of a third party merely to determine and record the condition of the goods so that they can be resold or used to reduce the stake in controversy. "Conformity", at one end of the scale of possible issues, includes the whole question of interpretation of the agreement and its legal effect, the state of the goods in regard to quality and condition, whether any defects are due to factors which operate at the risk of the buyer, and the degree of non-conformity where that may be material. "Condition", at the other end of the scale, includes nothing but the degree of damage or deterioration which the goods show. Paragraph (b) (A.C.A. § 4-2-515(b)) is intended to reach any point in the gamut which the parties may agree upon.

The principle of the section on reserva-

tion of rights reinforces this paragraph in simplifying such adjustments as the parties wish to make in partial settlement while reserving their rights as to any further points. Paragraph (b) (A.C.A. § 4-2-515(b)) also suggests the use of arbitration, where desired, of any points left open, but nothing in this section is intended to repeal or amend any statute governing arbitration. Where any question arises as to the extent of the parties' agreement under the paragraph, the presumption should be that it was meant to extend only to the relation between the contract description and the goods as delivered, since that is what a craftsman in the trade would normally be expected to report upon. Finally, a written and authenticated report of inspection or tests by a third party, whether or not sampling has been practicable, is entitled to be admitted as evidence under this Act, for it is a third party document.

#### *Cross References:*

Point 2: Sections 2-513(3) (A.C.A. § 4-2-513(3)), 2-706 (A.C.A. § 4-2-706) and 2-711(2) (A.C.A. § 4-2-711(2)) and Article 5 (Chapter 5).

Point 3: Sections 1-202 (A.C.A. § 4-1-202) and 1-207 (A.C.A. § 4-1-207).

#### *Definitional Cross References:*

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

### **Comment to § 2-601 (A.C.A. § 4-2-601)**

*Prior Uniform Statutory Provision:* No one general equivalent provision but numerous provisions, dealing with situations of non-conformity where buyer may accept or reject, including Sections 11, 44 and 69(1), Uniform Sales Act.

*Changes:* Partial acceptance in good faith is recognized and the buyer's remedies on the contract for breach of warranty and the like, where the buyer has returned the goods after transfer of title, are no longer barred.

*Purposes of Changes:* To make it clear that:

1. A buyer accepting a non-conforming tender is not penalized by the loss of any remedy otherwise open to him. This policy extends to cover and regulate the acceptance of a part of any lot improperly tendered in any case where the price can reasonably be apportioned. Partial acceptance is permitted whether the part of the goods accepted conforms or not. The only limitation on partial acceptance is that good faith and commercial reasonableness must be used to avoid undue impairment of the value of the remaining portion of the goods. This is the reason for the insistence on the "commercial unit" in para-

graph (c) (A.C.A. § 4-2-601(c)). In this respect, the test is not only what unit has been the basis of contract, but whether the partial acceptance produces so materially adverse an effect on the remainder as to constitute bad faith.

2. Acceptance made with the knowledge of the other party is final. An original refusal to accept may be withdrawn by a later acceptance if the seller has indicated that he is holding the tender open. However, if the buyer attempts to accept, either in whole or in part, after his original rejection has caused the seller to arrange for other disposition of the goods, the buyer must answer for any ensuing damage since the next section provides that any exercise of ownership after rejection is wrongful as against the seller. Further, he is liable even though the seller may choose to treat his action as acceptance rather than conversion, since the damage flows from the misleading notice. Such arrangements for resale or other disposition of the goods by the seller must be viewed as within the normal contemplation of a buyer who has given notice of

rejection. However, the buyer's attempts in good faith to dispose of defective goods where the seller has failed to give instructions within a reasonable time are not to be regarded as an acceptance.

*Cross References:*

Sections 2-602(2)(a) (A.C.A. § 4-2-602(2)(a)), 2-612 (A.C.A. § 4-2-612), 2-718 (A.C.A. § 4-2-718) and 2-719 (A.C.A. § 4-2-719).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Commercial unit". Section 2-105 (A.C.A. § 4-2-105).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Installment contract". Section 2-612 (A.C.A. § 4-2-612).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-602 (A.C.A. § 4-2-602)**

*Prior Uniform Statutory Provision:* Section 50, Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:* To make it clear that:

1. A tender or delivery of goods made pursuant to a contract of sale, even though wholly non-conforming, requires affirmative action by the buyer to avoid acceptance. Under subsection (1) (A.C.A. § 4-2-602(1)), therefore, the buyer is given a reasonable time to notify the seller of his rejection, but without such seasonable notification his rejection is ineffective. The sections of this Article (Chapter) dealing with inspection of goods must be read in connection with the buyer's reasonable time for action under this subsection. Contract provisions limiting the time for rejection fall within the rule of the section on "Time" and are effective if the time set gives the buyer a reasonable time for discovery of defects. What constitutes a due "notifying" of rejection by the buyer to the seller is defined in Section 1-201 (A.C.A. § 4-1-201).

2. Subsection (2) (A.C.A. § 4-2-602(2)) lays down the normal duties of the buyer upon rejection, which flow from the relationship of the parties. Beyond his duty to hold the goods with reasonable care for the buyer's disposition, this section continues the policy of prior uniform legislation in generally relieving the buyer from any duties with respect to them, except when the circumstances impose the limited obligation of salvage upon him under the next section.

3. The present section applies only to rightful rejection by the buyer. If the seller has made a tender which in all respects conforms to the contract, the buyer has a positive duty to accept and his failure to do so constitutes a "wrongful rejection" which gives the seller immediate remedies for breach. Subsection (3) (A.C.A. § 4-2-602(3)) is included here to emphasize the sharp distinction between the rejection of an improper tender and the non-acceptance which is a breach by the buyer.

4. The provisions of this section are to be appropriately limited or modified when a negotiation is in process.



*Cross References:*

Point 1: Sections 1-201 (A.C.A. § 4-1-201), 1-204(1) (A.C.A. § 4-1-204(1)) and (3) (A.C.A. § 4-1-204(3)), 2-512(2) (A.C.A. § 4-2-512(2)), 2-513(1) (A.C.A. § 4-2-513(1)) and 2-606(1)(b) (A.C.A. § 4-2-606(1)(b)).

Point 2: Section 2-603(1) (A.C.A. § 4-2-603(1)).

Point 3: Section 2-703 (A.C.A. § 4-2-703).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Commercial unit". Section 2-105 (A.C.A. § 4-2-105).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Merchant". Section 2-104 (A.C.A. § 4-2-104).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-603 (A.C.A. § 4-2-603)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. This section recognizes the duty imposed upon the merchant buyer by good faith and commercial practice to follow any reasonable instructions of the seller as to reshipping, storing, delivery to a third party, reselling or the like. Subsection (1) (A.C.A. § 4-2-603(1)) goes further and extends the duty to include the making of reasonable efforts to effect a salvage sale where the value of the goods is threatened and the seller's instructions do not arrive in time to prevent serious loss.

2. The limitations on the buyer's duty to resell under subsection (1) (A.C.A. § 4-2-603(1)) are to be liberally construed. The buyer's duty to resell under this section arises from commercial necessity and thus is present only when the seller has "no agent or place of business at the market of rejection". A financing agency which is acting in behalf of the seller in handling the documents rejected by the buyer is sufficiently the seller's agent to lift the burden of salvage resale from the buyer. (See provisions of Sections 4-503 (A.C.A. § 4-4-503) and 5-112 (A.C.A. § 4-5-112) on bank's duties with respect to rejected documents.) The buyer's duty to resell is extended only to goods in his "possession or control", but these are intended as words of wide, rather than narrow, import. In effect, the measure of the buyer's "control" is whether he can practicably

effect control without undue commercial burden.

3. The explicit provisions for reimbursement and compensation to the buyer in subsection (2) (A.C.A. § 4-2-603(2)) are applicable and necessary only where he is not acting under instructions from the seller. As provided in subsection (1) (A.C.A. § 4-2-603(1)) the seller's instructions to be "reasonable" must on demand of the buyer include indemnity for expenses.

4. Since this section makes the resale of perishable goods an affirmative duty in contrast to a mere right to sell as under the case law, subsection (3) (A.C.A. § 4-2-603(3)) makes it clear that the buyer is liable only for the exercise of good faith in determining whether the value of the goods is sufficiently threatened to justify a quick resale or whether he has waited a sufficient length of time for instructions, or what a reasonable means and place of resale is.

5. A buyer who fails to make a salvage sale when his duty to do so under this section has arisen is subject to damages pursuant to the section on liberal administration of remedies.

*Cross References:*

Point 2: Sections 4-503 (A.C.A. § 4-4-503) and 5-112 (A.C.A. § 4-5-112).

Point 5: Section 1-106 (A.C.A. § 4-1-106). Compare generally Section 2-706 (A.C.A. § 4-2-706).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Merchant". Section 2-104 (A.C.A. § 4-2-104).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-604 (A.C.A. § 4-2-604)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

The basic purpose of this section is twofold: on the one hand it aims at reducing the stake in dispute and on the other at avoiding the pinning of a technical "acceptance" on a buyer who has taken steps towards realization on or preservation of the goods in good faith. This section is essentially a salvage section and the buyer's right to act under it is conditioned upon (1) nonconformity of the goods, (2) due notification of rejection to the seller under the section on manner of rejection, and (3) the absence of any instructions from the seller which the merchant-buyer has a duty to follow under the preceding section.

This section is designed to accord all reasonable leeway to a rightfully rejecting buyer acting in good faith. The listing of what the buyer may do in the absence of instructions from the seller is intended to

be not exhaustive but merely illustrative. This is not a "merchant's" section and the options are pure options given to merchant and nonmerchant buyers alike. The merchant-buyer, however, may in some instances be under a duty rather than an option to resell under the provisions of the preceding section.

*Cross References:*

Sections 2-602(1) (A.C.A. § 4-2-602(1)), and 2-603(1) (A.C.A. § 4-2-603(1)) and 2-706 (A.C.A. § 4-2-706).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-605 (A.C.A. § 4-2-605)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. The present section rests upon a policy of permitting the buyer to give a quick and informal notice of defects in a tender without penalizing him for omissions in his statement, while at the same time protecting a seller who is reasonably misled by the buyer's failure to state curable defects.

2. Where the defect in a tender is one which could have been cured by the seller, a buyer who merely rejects the delivery without stating his objections to it is probably acting in commercial bad faith and seeking to get out of a deal which has become unprofitable. Subsection (1)(a) (A.C.A. § 4-2-605(1)(a)), following the general policy of this Article (Chapter) which looks to preserving the deal wher-

ever possible, therefore insists that the seller's right to correct his tender in such circumstances be protected.

3. When the time for cure is past, subsection (1)(b) (A.C.A. § 4-2-605(1)(b)) makes it plain that a seller is entitled upon request to a final statement of objections upon which he can rely. What is needed is that he make clear to the buyer exactly what is being sought. A formal demand under paragraph (b) (A.C.A. § 4-2-605(1)(b)) will be sufficient in the case of a merchant-buyer.

4. Subsection (2) (A.C.A. § 4-2-605(2)) applies to the particular case of documents the same principle which the section on effects of acceptance applies to the case of goods. The matter is dealt with in this section in terms of "waiver" of objections rather than of right to revoke acceptance, partly to avoid any confusion with



the problems of acceptance of goods and partly because defects in documents which are not taken as grounds for rejection are generally minor ones. The only defects concerned in the present subsection are defects in the documents which are apparent on their face. Where payment is required against the documents they must be inspected before payment, and the payment then constitutes acceptance of the documents. Under the section dealing with this problem, such acceptance of the documents does not constitute an acceptance of the goods or impair any options or remedies of the buyer for their improper delivery. Where the documents are delivered without requiring such contemporary action as payment from the buyer, the reason of the next section on what constitutes acceptance of goods applies. Their acceptance by non-objection is therefore postponed until after a reason-

able time for their inspection. In either situation, however, the buyer "waives" only what is apparent on the face of the documents.

*Cross References:*

Point 2: Section 2-508 (A.C.A. § 4-2-508).

Point 4: Sections 2-512(2) (A.C.A. § 4-2-512(2)), 2-606(1)(b) (A.C.A. § 4-2-606(1)(b)), 2-607(2) (A.C.A. § 4-2-607(2)).

*Definitional Cross References:*

"Between Merchants". Section 2-104 (A.C.A. § 4-2-104).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Writing" and "written". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-606 (A.C.A. § 4-2-606)**

*Prior Uniform Statutory Provision:* Section 48, Uniform Sales Act.

*Changes:* Rewritten, the qualification in paragraph (c) (A.C.A. § 4-2-606(1)(c)) and subsection (2) (A.C.A. § 4-2-606(2)) being new; otherwise the general policy of the prior legislation is continued.

*Purposes of Changes and New Matter:* To make it clear that:

1. Under this Article (Chapter) "acceptance" as applied to goods means that the buyer, pursuant to the contract, takes particular goods which have been appropriated to the contract as his own, whether or not he is obligated to do so, and whether he does so by words, action, or silence when it is time to speak. If the goods conform to the contract, acceptance amounts only to the performance by the buyer of one part of his legal obligation.

2. Under this Article (Chapter) acceptance of goods is always acceptance of identified goods which have been appropriated to the contract or are appropriated by the contract. There is no provision for "acceptance of title" apart from acceptance in general, since acceptance of title is not material under this Article (Chapter) to the detailed rights and duties of the parties. (See Section 2-401 (A.C.A. § 4-2-401)). The refinements of the older law

between acceptance of goods and of title become unnecessary in view of the provisions of the sections on effect and revocation of acceptance, on effects of identification and on risk of loss, and those sections which free the seller's and buyer's remedies from the complications and confusions caused by the question of whether title has or has not passed to the buyer before breach.

3. Under paragraph (a) (A.C.A. § 4-2-606(1)(a)), payment made after tender is always one circumstance tending to signify acceptance of the goods but in itself it can never be more than one circumstance and is not conclusive. Also, a conditional communication of acceptance always remains subject to its expressed conditions.

4. Under paragraph (c) (A.C.A. § 4-2-606(1)(c)), any action taken by the buyer, which is inconsistent with his claim that he has rejected the goods, constitutes an acceptance. However, the provisions of paragraph (c) (A.C.A. § 4-2-606(1)(c)) are subject to the sections dealing with rejection by the buyer which permit the buyer to take certain actions with respect to the goods pursuant to his options and duties imposed by those sections, without effecting an acceptance of the goods. The second clause of paragraph (c) (A.C.A. § 4-2-606(1)(c)) modifies some of the prior case

law and makes it clear that "acceptance" in law based on the wrongful act of the acceptor is acceptance only as against the wrongdoer and then only at the option of the party wronged.

In the same manner in which a buyer can bind himself, despite his insistence that he is rejecting or has rejected the goods, by an act inconsistent with the seller's ownership under paragraph (c) (A.C.A. § 4-2-606(1)(c)), he can obligate himself by a communication of acceptance despite a prior rejection under paragraph (a) (A.C.A. § 4-2-606(1)(a)). However, the sections on buyer's rights on improper delivery and on the effect of rightful rejection, make it clear that after he once rejects a tender, paragraph (a) (A.C.A. § 4-2-606(1)(a)) does not operate in favor of the buyer unless the seller has re-tendered the goods or has taken affirmative action indicating that he is holding the tender open. See also Comment 2 to Section 2-601 (A.C.A. § 4-2-601).

5. Subsection (2) (A.C.A. § 4-2-606(2))

supplements the policy of the section on buyer's rights on improper delivery, recognizing the validity of a partial acceptance but insisting that the buyer exercise this right only as to whole commercial units.

*Cross References:*

Point 2: Sections 2-401 (A.C.A. § 4-2-401), 2-509 (A.C.A. § 4-2-509), 2-510 (A.C.A. § 4-2-510), 2-607 (A.C.A. § 4-2-607), 2-608 (A.C.A. § 4-2-608) and Part 7.

Point 4: Sections 2-601 through 2-604 (A.C.A. §§ 4-2-601 through 4-2-604).

Point 5: Section 2-601 (A.C.A. § 4-2-601).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Commercial unit". Section 2-105 (A.C.A. § 4-2-105).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-607 (A.C.A. § 4-2-607)\***

*Prior Uniform Statutory Provision:* Subsection (1) (A.C.A. § 4-2-607(1)) — Section 41, Uniform Sales Act; Subsections (2) (A.C.A. § 4-2-607(2)) and (3) (A.C.A. § 4-2-607(3)) — Sections 49 and 69, Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:* To continue the prior basic policies with respect to acceptance of goods while making a number of minor though material changes in the interest of simplicity and commercial convenience so that:

1. Under subsection (1) (A.C.A. § 4-2-607(1)), once the buyer accepts a tender the seller acquires a right to its price on the contract terms. In cases of partial acceptance, the price of any part accepted is, if possible, to be reasonably apportioned, using the type of apportionment familiar to the courts in quantum valebat cases to be determined in terms of "the contract rate," which is the rate determined from the bargain in fact (the agreement) after the rules and policies of this Article (Chapter) have been brought to bear.

2. Under subsection (2) (A.C.A. § 4-2-

607(2)) acceptance of goods precludes their subsequent rejection. Any return of the goods thereafter must be by way of revocation of acceptance under the next section. Revocation is unavailable for a nonconformity known to the buyer at the time of acceptance, except where the buyer has accepted on the reasonable assumption that the nonconformity would be seasonably cured.

3. All other remedies of the buyer remain unimpaired under subsection (2) (A.C.A. § 4-2-607(2)). This is intended to include the buyer's full rights with respect to future installments despite his acceptance of any earlier nonconforming installment.

4. The time of notification is to be determined by applying commercial standards to a merchant buyer. "A reasonable time" for notification from a retail consumer is to be judged by different standards so that in his case it will be extended, for the rule of requiring notification is designed to defeat commercial bad faith, not to deprive a good faith consumer of his remedy.

The content of the notification need merely be sufficient to let the seller know



that the transaction is still troublesome and must be watched. There is no reason to require that the notification which saves the buyer's rights under this section must include a clear statement of all the objections that will be relied on by the buyer, as under the section covering statements of defects upon rejection (Section 2-605 (A.C.A. § 4-2-605)). Nor is there reason for requiring the notification to be a claim for damages or of any threatened litigation or other resort to a remedy. The notification which saves the buyer's rights under this Article (Chapter) need only be such as informs the seller that the transaction is claimed to involve a breach, and thus opens the way for normal settlement through negotiation.

5. Under this Article (Chapter) various beneficiaries are given rights for injuries sustained by them because of the seller's breach of warranty. Such a beneficiary does not fall within the reason of the present section in regard to discovery of defects and the giving of notice within a reasonable time after acceptance, since he has nothing to do with acceptance. However, the reason of this section does extend to requiring the beneficiary to notify the seller that an injury has occurred. What is said above, with regard to the extended time for reasonable notification from the lay consumer after the injury is also applicable here; but even a beneficiary can be properly held to the use of good faith in notifying, once he has had time to become aware of the legal situation.

6. Subsection (4) (A.C.A. § 4-2-607(4)) unambiguously places the burden of proof to establish breach on the buyer after acceptance. However, this rule becomes one purely of procedure when the tender accepted was nonconforming and the buyer has given the seller notice of breach under subsection (3) (A.C.A. § 4-2-607(3)). For subsection (2) (A.C.A. § 4-2-607(2)) makes it clear that acceptance leaves unimpaired the buyer's right to be made whole, and that right can be exercised by the buyer not only by way of cross-claim for damages, but also by way of recoupment in diminution or extinction of the price.

7. Subsections (3)(b) (A.C.A. § 4-2-607(3)(b)) and (5)(b) (A.C.A. § 4-2-607(5)(b)) give a warrantor against in-

fringement an opportunity to defend or compromise third-party claims or be relieved of his liability. Subsection (5)(a) (A.C.A. § 4-2-607(5)(a)) codifies for all warranties the practice of voucher to defend. Compare Section 3-803 (A.C.A. § 4-3-803). Subsection (6) (A.C.A. § 4-2-607(6)) makes these provisions applicable to the buyer's liability for infringement under Section 2-312 (A.C.A. § 4-2-312).

8. All of the provisions of the present section are subject to any explicit reservation of rights.

#### *Cross References:*

Point 1: Section 1-201 (A.C.A. § 4-1-201).

Point 2: Section 2-608 (A.C.A. § 4-2-608).

Point 4: Sections 1-204 (A.C.A. § 4-1-204) and 2-605 (A.C.A. § 4-2-605).

Point 5: Section 2-318 (A.C.A. § 4-2-318).

Point 6: Section 2-717 (A.C.A. § 4-2-717).

Point 7: Sections 2-312 (A.C.A. § 4-2-312) and 3-803 (A.C.A. § 4-3-803).

Point 8: Section 1-207 (A.C.A. § 4-1-207).

#### *Definitional Cross References:*

"Burden of establishing". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

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\*The Arkansas version of this section was amended by Acts 1969, No. 312, § 1, to correct typographical errors in the original enactment by the Arkansas General Assembly.

## Comment to § 2-608 (A.C.A. § 4-2-608)

*Prior Uniform Statutory Provision:* Section 69(1)(d), (3), (4), and (5), Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:* To make it clear that:

1. Although the prior basic policy is continued, the buyer is no longer required to elect between revocation of acceptance and recovery of damages for breach. Both are now available to him. The non-alternative character of the two remedies is stressed by the terms used in the present section. The section no longer speaks of "rescission," a term capable of ambiguous application either to transfer of title to the goods or to the contract of sale and susceptible also of confusion with cancellation for cause of an executed or executory portion of the contract. The remedy under this section is instead referred to simply as "revocation of acceptance" of goods tendered under a contract for sale and involves no suggestion of "election" of any sort.

2. Revocation of acceptance is possible only where the nonconformity substantially impairs the value of the goods to the buyer. For this purpose the test is not what the seller had reason to know at the time of contracting; the question is whether the nonconformity is such as will in fact cause a substantial impairment of value to the buyer though the seller had no advance knowledge as to the buyer's particular circumstances.

3. "Assurances" by the seller under paragraph (b) of subsection (1) (A.C.A. § 4-2-608(1)(b)) can rest as well in the circumstances or in the contract as in explicit language used at the time of delivery. The reason for recognizing such assurances is that they induce the buyer to delay discovery. These are the only assurances involved in paragraph (b) (A.C.A. § 4-2-608(1)(b)). Explicit assurances may be made either in good faith or bad faith. In either case any remedy accorded by this Article (Chapter) is available to the buyer under the section on remedies for fraud.

4. Subsection (2) (A.C.A. § 4-2-608(2)) requires notification of revocation of acceptance within a reasonable time after

discovery of the grounds for such revocation. Since this remedy will be generally resorted to only after attempts at adjustment have failed, the reasonable time period should extend in most cases beyond the time in which notification of breach must be given, beyond the time for discovery of nonconformity after acceptance and beyond the time for rejection after tender. The parties may by their agreement limit the time for notification under this section, but the same sanctions and considerations apply to such agreements as are discussed in the comment on manner and effect of rightful rejection.

5. The content of the notice under subsection (2) (A.C.A. § 4-2-608(2)) is to be determined in this case as in others by considerations of good faith, prevention of surprise, and reasonable adjustment. More will generally be necessary than the mere notification of breach required under the preceding section. On the other hand the requirements of the section on waiver of buyer's objections do not apply here. The fact that quick notification of trouble is desirable affords good ground for being slow to bind a buyer by his first statement. Following a general policy of this Article (Chapter), the requirements of the content of notification are less stringent in the case of a non-merchant buyer.

6. Under subsection (2) (A.C.A. § 4-2-608(2)) the prior policy is continued of seeking substantial justice in regard to the condition of goods restored to the seller. Thus the buyer may not revoke his acceptance if the goods have materially deteriorated except by reason of their own defects. Worthless goods, however, need not be offered back and minor defects in the articles reoffered are to be disregarded.

7. The policy of the section allowing partial acceptance is carried over into the present section and the buyer may revoke his acceptance, in appropriate cases, as to the entire lot or any commercial unit thereof.

*Cross References:*

Point 3: Section 2-723 (A.C.A. § 4-2-723).

Point 4: Sections 1-204 (A.C.A. § 4-1-204), 2-602 (A.C.A. § 4-2-602) and 2-607 (A.C.A. § 4-2-607).



Point 5: Sections 2-605 (A.C.A. § 4-2-605) and 2-607 (A.C.A. § 4-2-607).

Point 7: Section 2-601 (A.C.A. § 4-2-601).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Commercial unit". Section 2-105 (A.C.A. § 4-2-105).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Lot". Section 2-105 (A.C.A. § 4-2-105).  
 "Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-609 (A.C.A. § 4-2-609)**

*Prior Uniform Statutory Provision:* See Sections 53, 54(1)(b), 55 and 63(2), Uniform Sales Act.

*Purposes:*

1. The section rests on the recognition of the fact that the essential purpose of a contract between commercial men is actual performance and they do not bargain merely for a promise, or for a promise plus the right to win a law suit and that a continuing sense of reliance and security that the promised performance will be forthcoming when due, is an important feature of the bargain. If either the willingness or the ability of a party to perform declines materially between the time of contracting and the time for performance, the other party is threatened with the loss of a substantial part of what he has bargained for. A seller needs protection not merely against having to deliver on credit to a shaky buyer, but also against having to procure and manufacture the goods, perhaps turning down other customers. Once he has been given reason to believe that the buyer's performance has become uncertain, it is an undue hardship to force him to continue his own performance. Similarly, a buyer who believes that the seller's deliveries have become uncertain cannot safely wait for the due date of performance when he has been buying to assure himself of materials for his current manufacturing or to replenish his stock of merchandise.

2. Three measures have been adopted to meet the needs of commercial men in such situations. First, the aggrieved party is permitted to suspend his own performance and any preparation therefor, with

excuse for any resulting necessary delay, until the situation has been clarified. "Suspend performance" under this section means to hold up performance pending the outcome of the demand, and includes also the holding up of any preparatory action. This is the same principle which governs the ancient law of stoppage and seller's lien, and also of excuse of a buyer from prepayment if the seller's actions manifest that he cannot or will not perform. (Original Act, Section 63(2)).

Secondly, the aggrieved party is given the right to require adequate assurance that the other party's performance will be duly forthcoming. This principle is reflected in the familiar clauses permitting the seller to curtail deliveries if the buyer's credit becomes impaired, which when held within the limits of reasonableness and good faith actually express no more than the fair business meaning of any commercial contract.

Third, and finally, this section provides the means by which the aggrieved party may treat the contract as broken if his reasonable grounds for insecurity are not cleared up within a reasonable time. This is the principle underlying the law of anticipatory breach, whether by way of defective part performance or by repudiation. The present section merges these three principles of law and commercial practice into a single theory of general application to all sales agreements looking to future performance.

3. Subsection (2) (A.C.A. § 4-2-609(2)) of the present section requires that "reasonable" grounds and "adequate" assurance as used in subsection (1) (A.C.A. § 4-2-609(1)) be defined by commercial

rather than legal standards. The express reference to commercial standards carries no connotation that the obligation of good faith is not equally applicable here.

Under commercial standards and in accord with commercial practice, a ground for insecurity need not arise from or be directly related to the contract in question. The law as to "dependence" or "independence" of promises within a single contract does not control the application of the present section.

Thus a buyer who falls behind in "his account" with the seller, even though the items involved have to do with separate and legally distinct contracts, impairs the seller's expectation of due performance. Again, under the same test, a buyer who requires precision parts which he intends to use immediately upon delivery, may have reasonable grounds for insecurity if he discovers that his seller is making defective deliveries of such parts to other buyers with similar needs. Thus, too, in a situation such as arose in *Jay Dreher Corporation v. Delco Appliance Corporation*, 93 F.2d 275 (C.C.A.2, 1937), where a manufacturer gave a dealer an exclusive franchise for the sale of his product but on two or three occasions breached the exclusive dealing clause, although there was no default in orders, deliveries or payments under the separate sales contract between the parties, the aggrieved dealer would be entitled to suspend his performance of the contract for sale under the present section and to demand assurance that the exclusive dealing contract would be lived up to. There is no need for an explicit clause tying the exclusive franchise into the contract for the sale of goods since the situation itself ties the agreements together.

The nature of the sales contract enters also into the question of reasonableness. For example, a report from an apparently trustworthy source that the seller had shipped defective goods or was planning to ship them would normally give the buyer reasonable grounds for insecurity. But when the buyer has assumed the risk of payment before inspection of the goods, as in a sales contract on C.I.F. or similar cash against documents terms, that risk is not to be evaded by a demand for assurance. Therefore, no ground for insecurity would exist under this section unless the report went to a ground which would excuse payment by the buyer.

4. What constitutes "adequate" assurance of due performance is subject to the same test of factual conditions. For example, where the buyer can make use of a defective delivery, a mere promise by a seller of good repute that he is giving the matter his attention and that the defect will not be repeated, is normally sufficient. Under the same circumstances, however, a similar statement by a known corner-cutter might well be considered insufficient without the posting of a guaranty or, if so demanded by the buyer, a speedy replacement of the delivery involved. By the same token where a delivery has defects, even though easily curable, which interfere with easy use by the buyer, no verbal assurance can be deemed adequate which is not accompanied by replacement, repair, money-allowance, or other commercially reasonable cure.

A fact situation such as arose in *Corn Products Refining Co. v. Fasola*, 94 N.J.L. 181, 109 A. 505 (1920) offers illustration both of reasonable grounds for insecurity and "adequate" assurance. In that case a contract for the sale of oils on 30 days' credit, 2% off for payment within 10 days, provided that credit was to be extended to the buyer only if his financial responsibility was satisfactory to the seller. The buyer had been in the habit of taking advantage of the discount but at the same time that he failed to make his customary 10 day payment, the seller heard rumors, in fact false, that the buyer's financial condition was shaky. Thereupon, the seller demanded cash before shipment or security satisfactory to him. The buyer sent a good credit report from his banker, expressed willingness to make payments when due on the 30 day terms and insisted on further deliveries under the contract. Under this Article (Chapter) the rumors, although false, were enough to make the buyer's financial condition "unsatisfactory" to the seller under the contract clause. Moreover, the buyer's practice of taking the cash discounts is enough, apart from the contract clause, to lay a commercial foundation for suspicion when the practice is suddenly stopped. These matters, however, go only to the justification of the seller's demand for security, or his "reasonable grounds for insecurity".

The adequacy of the assurance given is not measured as in the type of "satisfac-



tion" situation affected with intangibles, such as in personal service cases, cases involving a third party's judgment as final, or cases in which the whole contract is dependent on one party's satisfaction, as in a sale on approval. Here, the seller must exercise good faith and observe commercial standards. This Article (Chapter) thus approves the statement of the court in *James B. Berry's Sons Co. of Illinois v. Monark Gasoline & Oil Co., Inc.*, 32 F.2d 74 (C.C.A.8, 1929), that the seller's satisfaction under such a clause must be based upon reason and must not be arbitrary or capricious; and rejects the purely personal "good faith" test of the *Corn Products Refining Co.* case, which held that in the seller's sole judgment, if for any reason he was dissatisfied, he was entitled to revoke the credit. In the absence of the buyer's failure to take the 2% discount as was his custom, the banker's report given in that case would have been "adequate" assurance under this Act, regardless of the language of the "satisfaction" clause. However, the seller is reasonably entitled to feel insecure at a sudden expansion of the buyer's use of a credit term, and should be entitled either to security or to a satisfactory explanation.

The entire foregoing discussion as to adequacy of assurance by way of explanation is subject to qualification when repeated occasions for the application of this section arise. This Act recognizes that repeated delinquencies must be viewed as cumulative. On the other hand, commercial sense also requires that if repeated claims for assurance are made under this section, the basis for these claims must be increasingly obvious.

5. A failure to provide adequate assurance of performance and thereby to re-establish the security of expectation, results in a breach only "by repudiation" under subsection (4) (A.C.A. § 4-2-609(4)). Therefore, the possibility is continued of retraction of the repudiation under the section dealing with that problem, unless the aggrieved party has acted on the breach in some manner.

The thirty day limit on the time to

provide assurance is laid down to free the question of reasonable time from uncertainty in later litigation.

6. Clauses seeking to give the protected party exceedingly wide powers to cancel or readjust the contract when ground for insecurity arises must be read against the fact that good faith is a part of the obligation of the contract and not subject to modification by agreement and includes, in the case of a merchant, the reasonable observance of commercial standards of fair dealing in the trade. Such clauses can thus be effective to enlarge the protection given by the present section to a certain extent, to fix the reasonable time within which requested assurance must be given, or to define adequacy of the assurance in any commercially reasonable fashion. But any clause seeking to set up arbitrary standards for action is ineffective under this Article (Chapter). Acceleration clauses are treated similarly in the Articles (Chapters) on Commercial Paper and Security Transactions.

#### *Cross References:*

Point 3: Section 1-203 (A.C.A. § 4-1-203).

Point 5: Section 2-611 (A.C.A. § 4-2-611).

Point 6: Sections 1-203 (A.C.A. § 4-1-203) and 1-208 (A.C.A. § 4-1-208) and Articles 3 (Chapter 3) and 9 (Chapter 9).

#### *Definitional Cross References:*

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Between Merchants". Section 2-104 (A.C.A. § 4-2-104).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-610 (A.C.A. § 4-2-610)**

*Prior Uniform Statutory Provision:* See Sections 63(2) and 65, Uniform Sales Act.

*Purposes:* To make it clear that:

1. With the problem of insecurity taken care of by the preceding section and with provision being made in this Article (Chapter) as to the effect of a defective delivery under an installment contract, anticipatory repudiation centers upon an overt communication of intention or an action which renders performance impossible or demonstrates a clear determination not to continue with performance.

Under the present section when such a repudiation substantially impairs the value of the contract, the aggrieved party may at any time resort to his remedies for breach, or he may suspend his own performance while he negotiates with, or awaits performance by, the other party, but if he awaits performance beyond a commercially reasonable time he cannot recover resulting damages which he should have avoided.

2. It is not necessary for repudiation that performance be made literally and utterly impossible. Repudiation can result from action which reasonably indicates a rejection of the continuing obligation. And, a repudiation automatically results under the preceding section on insecurity when a party fails to provide adequate assurance of due future performance within thirty days after a justifiable demand therefor has been made. Under the language of this section, a demand by one or both parties for more than the contract calls for in the way of counter-performance is not in itself a repudiation nor does it invalidate a plain expression of desire for future performance. However, when under a fair reading it amounts to a statement of intention not to perform except on conditions which go beyond the contract, it becomes a repudiation.

3. The test chosen to justify an aggrieved party's action under this section is the same as that in the section on breach in installment contracts — namely the substantial value of the contract. The most useful test of substantial value is to determine whether material inconvenience or injustice will result if the aggrieved party is forced to wait and receive an ultimate tender minus the part or aspect repudiated.

4. After repudiation, the aggrieved party may immediately resort to any remedy he chooses provided he moves in good faith (see Section 1-203 (A.C.A. § 4-1-203)). Inaction and silence by the aggrieved party may leave the matter open but it cannot be regarded as misleading the repudiating party. Therefore the aggrieved party is left free to proceed at any time with his options under this section, unless he has taken some positive action which in good faith requires notification to the other party before the remedy is pursued.

*Cross References:*

Point 1: Sections 2-609 (A.C.A. § 4-2-609) and 2-612 (A.C.A. § 4-2-612).

Point 2: Section 2-609 (A.C.A. § 4-2-609).

Point 3: Section 2-612 (A.C.A. § 4-2-612).

Point 4: Section 1-203 (A.C.A. § 4-1-203).

*Definitional Cross References:*

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-611 (A.C.A. § 4-2-611)**

*Prior Uniform Statutory Provision:* None.

*Purposes:* To make it clear that:

1. The repudiating party's right to reinstate the contract is entirely dependent upon the action taken by the aggrieved party. If the latter has cancelled the con-

tract or materially changed his position at any time after the repudiation, there can be no retraction under this section.

2. Under subsection (2) (A.C.A. § 4-2-611(2)) an effective retraction must be accompanied by any assurances demanded under the section dealing with



right to adequate assurance. A repudiation is of course sufficient to give reasonable ground for insecurity and to warrant a request for assurance as an essential condition of the retraction. However, after a timely and unambiguous expression of retraction, a reasonable time for the assurance to be worked out should be allowed by the aggrieved party before cancellation.

*Cross References:*

Point 2: Section 2-609 (A.C.A. § 4-2-609).

*Definitional Cross References:*

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Cancellation". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-612 (A.C.A. § 4-2-612)**

*Prior Uniform Statutory Provision:* Section 45(2), Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:* To continue prior law but to make explicit the more mercantile interpretation of many of the rules involved, so that:

1. The definition of an installment contract is phrased more broadly in this Article (Chapter) so as to cover installment deliveries tacitly authorized by the circumstances or by the option of either party.

2. In regard to the apportionment of the price for separate payment this Article (Chapter) applies the more liberal test of what can be apportioned rather than the test of what is clearly apportioned by the agreement. This Article (Chapter) also recognizes approximate calculation or apportionment of price subject to subsequent adjustment. A provision for separate payment for each lot delivered ordinarily means that the price is at least roughly calculable by units of quantity, but such a provision is not essential to an "installment contract." If separate acceptance of separate deliveries is contemplated, no generalized contrast between wholly "entire" and wholly "divisible" contracts has any standing under this Article (Chapter).

3. This Article (Chapter) rejects any approach which gives clauses such as "each delivery is a separate contract" their legalistically literal effect. Such contracts nonetheless call for installment deliveries. Even where a clause speaks of "a separate contract for all purposes", a commercial reading of the language under the

section on good faith and commercial standards requires that the singleness of the document and the negotiation, together with the sense of the situation, prevail over any uncommercial and legalistic interpretation.

4. One of the requirements for rejection under subsection (2) (A.C.A. § 4-2-612(2)) is nonconformity substantially impairing the value of the installment in question. However, an installment agreement may require accurate conformity in quality as a condition to the right to acceptance if the need for such conformity is made clear either by express provision or by the circumstances. In such a case the effect of the agreement is to define explicitly what amounts to substantial impairment of value impossible to cure. A clause requiring accurate compliance as a condition to the right to acceptance must, however, have some basis in reason, must avoid imposing hardship by surprise and is subject to waiver or to displacement by practical construction.

Substantial impairment of the value of an installment can turn not only on the quality of the goods but also on such factors as time, quantity, assortment, and the like. It must be judged in terms of the normal or specifically known purposes of the contract. The defect in required documents refers to such matters as the absence of insurance documents under a C.I.F. contract, falsity of a bill of lading, or one failing to show shipment within the contract period or to the contract destination. Even in such cases, however, the provisions on cure of tender apply if appropriate documents are readily procurable.

5. Under subsection (2) (A.C.A. § 4-2-612(2)) an installment delivery must be accepted if the nonconformity is curable and the seller gives adequate assurance of cure. Cure of nonconformity of an installment in the first instance can usually be afforded by an allowance against the price, or in the case of reasonable discrepancies in quantity either by a further delivery or a partial rejection. This Article (Chapter) requires reasonable action by a buyer in regard to discrepant delivery and good faith requires that the buyer make any reasonable minor outlay of time or money necessary to cure an overshipment by severing out an acceptable percentage thereof. The seller must take over a cure which involves any material burden; the buyer's obligation reaches only to cooperation. Adequate assurance for purposes of subsection (2) (A.C.A. § 4-2-612(2)) is measured by the same standards as under the section on right to adequate assurance of performance.

6. Subsection (3) (A.C.A. § 4-2-612(3)) is designed to further the continuance of the contract in the absence of an overt cancellation. The question arising when an action is brought as to a single installment only is resolved by making such action waive the right of cancellation. This involves merely a defect in one or more installments, as contrasted with the situation where there is a true repudiation within the section on anticipatory repudiation. Whether the nonconformity in any given installment justifies cancellation as to the future depends, not on whether such nonconformity indicates an intent or likelihood that the future deliveries will also be defective, but whether the nonconformity substantially impairs the value of the whole contract. If only the seller's security in regard to future installments is impaired, he has the right to demand adequate assurances of proper future performance but has not an immediate right to cancel the entire contract. It is clear under this Article (Chapter), however, that defects in prior installments are cumulative in effect, so that acceptance does not wash out the defect "waived." Prior policy is continued, putting the rule as to

buyer's default on the same footing as that in regard to seller's default.

7. Under the requirement of seasonable notification of cancellation under subsection (3) (A.C.A. § 4-2-612(3)), a buyer who accepts a nonconforming installment which substantially impairs the value of the entire contract should properly be permitted to withhold his decision as to whether or not to cancel pending a response from the seller as to claim for cure or adjustment. Similarly, a seller may withhold a delivery pending payment for prior ones, at the same time delaying his decision as to cancellation. A reasonable time for notifying of cancellation, judged by commercial standards under the section on good faith, extends of course to include the time covered by any reasonable negotiation in good faith. However, during this period the defaulting party is entitled, on request, to know whether the contract is still in effect, before he can be required to perform further.

#### *Cross References:*

Point 2: Sections 2-307 (A.C.A. § 4-2-307) and 2-607 (A.C.A. § 4-2-607).

Point 3: Section 1-203 (A.C.A. § 4-1-203).

Point 5: Sections 2-208 (A.C.A. § 4-2-208) and 2-609 (A.C.A. § 4-2-609).

Point 6: Section 2-610 (A.C.A. § 4-2-610).

#### *Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Cancellation". Section 2-106 (A.C.A. § 4-2-106).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Lot". Section 2-105 (A.C.A. § 4-2-105).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).



**Comment to § 2-613 (A.C.A. § 4-2-613)**

*Prior Uniform Statutory Provision:* Sections 7 and 8, Uniform Sales Act.

*Changes:* Rewritten, the basic policy being continued but the test of a "divisible" or "indivisible" sale or contract being abandoned in favor of adjustment in business terms.

*Purposes of Changes:*

1. Where goods whose continued existence is presupposed by the agreement are destroyed without fault of either party, the buyer is relieved from his obligation but may at his option take the surviving goods at a fair adjustment. "Fault" is intended to include negligence and not merely wilful wrong. The buyer is expressly given the right to inspect the goods in order to determine whether he wishes to avoid the contract entirely or to take the goods with a price adjustment.

2. The section applies whether the goods were already destroyed at the time of contracting without the knowledge of either party or whether they are destroyed subsequently but before the risk of loss passes to the buyer. Where under the agreement, including of course usage of trade, the risk has passed to the buyer before the casualty, the section has no application. Beyond this, the essential question in determining whether the rules

of this section are to be applied is whether the seller has or has not undertaken the responsibility for the continued existence of the goods in proper condition through the time of agreed or expected delivery.

3. The section on the term "no arrival, no sale" makes clear that delay in arrival, quite as much as physical change in the goods, gives the buyer the options set forth in this section.

*Cross References:*

Point 3: Section 2-324 (A.C.A. § 4-2-324).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Fault". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-614 (A.C.A. § 4-2-614)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-2-614(1)) requires the tender of a commercially reasonable substituted performance where agreed to facilities have failed or become commercially impracticable. Under this Article (Chapter), in the absence of specific agreement, the normal or usual facilities enter into the agreement either through the circumstances, usage of trade or prior course of dealing.

This section appears between Section 2-613 (A.C.A. § 4-2-613) on casualty to identified goods and the next section on excuse by failure of presupposed conditions, both of which deal with excuse and complete avoidance of the contract where the occurrence or non-occurrence of a contingency which was a basic assumption of

the contract makes the expected performance impossible. The distinction between the present section and those sections lies in whether the failure or impossibility of performance arises in connection with an incidental matter or goes to the very heart of the agreement. The differing lines of solution are contrasted in a comparison of *International Paper Co. v. Rockefeller*, 161 App.Div. 180, 146 N.Y.S. 371 (1914) and *Meyer v. Sullivan*, 40 Cal.App. 723, 181 P. 847 (1919). In the former case a contract for the sale of spruce to be cut from a particular tract of land was involved. When a fire destroyed the trees growing on that tract the seller was held excused since performance was impossible. In the latter case the contract called for delivery of wheat "f.o.b. Kosmos Steamer at Seattle." The war led to can-

cellation of that line's sailing schedule after space had been duly engaged and the buyer was held entitled to demand substituted delivery at the warehouse on the line's loading dock. Under this Article (Chapter), of course, the seller would also be entitled, had the market gone the other way, to make a substituted tender in that manner.

There must, however, be a true commercial impracticability to excuse the agreed to performance and justify a substituted performance. When this is the case a reasonable substituted performance tendered by either party should excuse him from strict compliance with contract terms which do not go to the essence of the agreement.

2. The substitution provided in this section as between buyer and seller does not carry over into the obligation of a financing agency under a letter of credit, since such an agency is entitled to performance which is plainly adequate on its face and without need to look into commercial evidence outside of the documents. See Article 5 (Chapter 5), especially Sections 5-102 (A.C.A. § 4-5-102), 5-103 (A.C.A.

§ 4-5-103), 5-109 (A.C.A. § 4-5-109), 5-110 (A.C.A. § 4-5-110), 5-114 (A.C.A. § 4-5-114).

3. Under subsection (2) (A.C.A. § 4-2-614(2)) where the contract is still executory on both sides, the seller is permitted to withdraw unless the buyer can provide him with a commercially equivalent return despite the governmental regulation. Where, however, only the debt for the price remains, a larger leeway is permitted. The buyer may pay in the manner provided by the regulation even though this may not be commercially equivalent provided that the regulation is not "discriminatory, oppressive or predatory."

*Cross References:*

Point 2: Article 5 (Chapter 5).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Fault". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-615 (A.C.A. § 4-2-615)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. This section excuses a seller from timely delivery of goods contracted for, where his performance has become commercially impracticable because of unforeseen supervening circumstances not within the contemplation of the parties at the time of contracting. The destruction of specific goods and the problem of the use of substituted performance on points other than delay or quantity, treated elsewhere in this Article (Chapter), must be distinguished from the matter covered by this section.

2. The present section deliberately refrains from any effort at an exhaustive expression of contingencies and is to be interpreted in all cases sought to be brought within its scope in terms of its underlying reason and purpose.

3. The first test for excuse under this Article (Chapter) in terms of basic assumption is a familiar one. The additional test of commercial impracticability (as contrasted with "impossibility," "frustra-

tion of performance" or "frustration of the venture") has been adopted in order to call attention to the commercial character of the criterion chosen by this Article (Chapter).

4. Increased cost alone does not excuse performance unless the rise in cost is due to some unforeseen contingency which alters the essential nature of the performance. Neither is a rise or a collapse in the market in itself a justification, for that is exactly the type of business risk which business contracts made at fixed prices are intended to cover. But a severe shortage of raw materials or of supplies due to a contingency such as war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like, which either causes a marked increase in cost or altogether prevents the seller from securing supplies necessary to his performance, is within the contemplation of this section. (See *Ford & Sons, Ltd. v. Henry Leatham & Sons, Ltd.*, 21 Com. Cas. 55 (1915, K.B.D.).)

5. Where a particular source of supply is exclusive under the agreement and fails



through casualty, the present section applies rather than the provision on destruction or deterioration of specific goods. The same holds true where a particular source of supply is shown by the circumstances to have been contemplated or assumed by the parties at the time of contracting. (See *Davis Co. v. Hoffmann-LaRoche Chemical Works*, 178 App.Div. 855, 166 N.Y.S. 179 (1917) and *International Paper Co. v. Rockefeller*, 161 App.Div. 180, 146 N.Y.S. 371 (1914)). There is no excuse under this section, however, unless the seller has employed all due measures to assure himself that his source will not fail. (See *Canadian Industrial Alcohol Co., Ltd. v. Dunbar Molasses Co.*, 258 N.Y. 194, 179 N.E. 383, 80 A.L.R. 1173 (1932) and *Washington Mfg. Co. v. Midland Lumber Co.*, 113 Wash. 593, 194 P. 777 (1921).)

In the case of failure of production by an agreed source for causes beyond the seller's control, the seller should, if possible, be excused since production by an agreed source is without more a basic assumption of the contract. Such excuse should not result in relieving the defaulting supplier from liability nor in dropping into the seller's lap an unearned bonus of damages over. The flexible adjustment machinery of this Article (Chapter) provides the solution under the provision on the obligation of good faith. A condition to his making good the claim of excuse is the turning over to the buyer of his rights against the defaulting source of supply to the extent of the buyer's contract in relation to which excuse is being claimed.

6. In situations in which neither sense nor justice is served by either answer when the issue is posed in flat terms of "excuse" or "no excuse," adjustment under the various provisions of this Article (Chapter) is necessary, especially the sections on good faith, on insecurity and assurance and on the reading of all provisions in the light of their purposes, and the general policy of this Act to use equitable principles in furtherance of commercial standards and good faith.

7. The failure of conditions which go to convenience or collateral values rather than to the commercial practicability of the main performance does not amount to a complete excuse. However, good faith and the reason of the present section and of the preceding one may properly be held to justify and even to require any needed

delay involved in a good faith inquiry seeking a readjustment of the contract terms to meet the new conditions.

8. The provisions of this section are made subject to assumption of greater liability by agreement and such agreement is to be found not only in the expressed terms of the contract but in the circumstances surrounding the contracting, in trade usage and the like. Thus the exemptions of this section do not apply when the contingency in question is sufficiently foreshadowed at the time of contracting to be included among the business risks which are fairly to be regarded as part of the dickered terms, either consciously or as a matter of reasonable, commercial interpretation from the circumstances. (See *Madeirense Do Brasil, S. A. v. Stulman-Emrick Lumber Co.*, 147 F.2d 399 (C.C.A., 2 Cir., 1945).) The exemption otherwise present through usage of trade under the present section may also be expressly negated by the language of the agreement. Generally, express agreements as to exemptions designed to enlarge upon or supplant the provisions of this section are to be read in the light of mercantile sense and reason, for this section itself sets up the commercial standard for normal and reasonable interpretation and provides a minimum beyond which agreement may not go.

Agreement can also be made in regard to the consequences of exemption as laid down in paragraphs (b) (A.C.A. § 4-2-615(b)) and (c) (A.C.A. § 4-2-615(c)) and the next section on procedure on notice claiming excuse.

9. The case of a farmer who has contracted to sell crops to be grown on designated land may be regarded as falling either within the section on casualty to identified goods or this section, and he may be excused, when there is a failure of the specific crop, either on the basis of the destruction of identified goods or because of the failure of a basic assumption of the contract.

Exemption of the buyer in the case of a "requirements" contract is covered by the "Output and Requirements" section both as to assumption and allocation of the relevant risks. But when a contract by a manufacturer to buy fuel or raw material makes no specific reference to a particular venture and no such reference may be drawn from the circumstances, commer-

cial understanding views it as a general deal in the general market and not conditioned on any assumption of the continuing operation of the buyer's plant. Even when notice is given by the buyer that the supplies are needed to fill a specific contract of an normal commercial kind, commercial understanding does not see such a supply contract as conditioned on the continuance of the buyer's further contract for outlet. On the other hand, where the buyer's contract is in reasonable commercial understanding conditioned on a definite and specific venture or assumption as, for instance, a war procurement sub-contract known to be based on a prime contract which is subject to termination, or a supply contract for a particular construction venture, the reason of the present section may well apply and entitle the buyer to the exemption.

10. Following its basic policy of using commercial practicability as a test for excuse, this section recognizes as of equal significance either a foreign or domestic regulation and disregards any technical distinctions between "law," "regulation," "order" and the like. Nor does it make the present action of the seller depend upon the eventual judicial determination of the legality of the particular governmental action. The seller's good faith belief in the validity of the regulation is the test under this Article (Chapter) and the best evidence of his good faith is the general commercial acceptance of the regulation. However, governmental interference cannot excuse unless it truly "supervenes" in such a manner as to be beyond the seller's assumption of risk. And any action by the party claiming excuse which causes or colludes in inducing the governmental action preventing his performance would be in breach of good faith and would destroy his exemption.

11. An excused seller must fulfill his contract to the extent which the supervening contingency permits, and if the situation is such that his customers are generally affected he must take account of all in supplying one. Subsections (a) (A.C.A. § 4-2-615(a)) and (b) (A.C.A. § 4-2-615(b)), therefore, explicitly permit in any proration a fair and reasonable attention to the needs of regular customers who are probably relying on spot orders for supplies. Customers at different stages of the

manufacturing process may be fairly treated by including the seller's manufacturing requirements. A fortiori, the seller may also take account of contracts later in date than the one in question. The fact that such spot orders may be closed at an advanced price causes no difficulty, since any allocation which exceeds normal past requirements will not be reasonable. However, good faith requires, when prices have advanced, that the seller exercise real care in making his allocations, and in case of doubt his contract customers should be favored and supplies prorated evenly among them regardless of price. Save for the extra care thus required by changes in the market, this section seeks to leave every reasonable business leeway to the seller.

#### *Cross References:*

Point 1: Sections 2-613 (A.C.A. § 4-2-613) and 2-614 (A.C.A. § 4-2-614).

Point 2: Section 1-102 (A.C.A. § 4-1-102).

Point 5: Sections 1-203 (A.C.A. § 4-1-203) and 2-613 (A.C.A. § 4-2-613).

Point 6: Sections 1-102 (A.C.A. § 4-1-102), 1-203 (A.C.A. § 4-1-203) and 2-609 (A.C.A. § 4-2-609).

Point 7: Section 2-614 (A.C.A. § 4-2-614).

Point 8: Sections 1-201 (A.C.A. § 4-1-201), 2-302 (A.C.A. § 4-2-302) and 2-616 (A.C.A. § 4-2-616).

Point 9: Sections 1-102 (A.C.A. § 4-1-102), 2-306 (A.C.A. § 4-2-306) and 2-613 (A.C.A. § 4-2-613).

#### *Definitional Cross References:*

"Between Merchants". Section 2-104 (A.C.A. § 4-2-104).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Merchant". Section 2-104 (A.C.A. § 4-2-104).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Seller". Section 2-103 (A.C.A. § 4-2-103).



**Comment to § 2-616 (A.C.A. § 4-2-616)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

This section seeks to establish simple and workable machinery for providing certainty as to when a supervening and excusing contingency “excuses” the delay, “discharges” the contract, or may result in a waiver of the delay by the buyer. When the seller notifies, in accordance with the preceding section, claiming excuse, the buyer may acquiesce, in which case the contract is so modified. No consideration is necessary in a case of this kind to support such a modification. If the buyer does not elect so to modify the contract, he may terminate it and under subsection (2) (A.C.A. § 4-2-616(2)) his silence after receiving the seller’s claim of excuse operates as such a termination. Subsection (3) (A.C.A. § 4-2-616(3)) denies effect to any contract clause made in advance of trouble which would require the buyer to stand ready to take delivery whenever the

seller is excused from delivery by unforeseen circumstances.

*Cross References:*

Point 1: Sections 2-209 (A.C.A. § 4-2-209) and 2-615 (A.C.A. § 4-2-615).

*Definitional Cross References:*

“Buyer”. Section 2-103 (A.C.A. § 4-2-103).

“Contract”. Section 1-201 (A.C.A. § 4-1-201).

“Installment contract”. Section 2-612 (A.C.A. § 4-2-612).

“Notification”. Section 1-201 (A.C.A. § 4-1-201).

“Reasonable time”. Section 1-204 (A.C.A. § 4-1-204).

“Seller”. Section 2-103 (A.C.A. § 4-2-103).

“Termination”. Section 2-106 (A.C.A. § 4-2-106).

“Written”. Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-701 (A.C.A. § 4-2-701)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

Whether a claim for breach of an obligation collateral to the contract for sale requires separate trial to avoid confusion of issues is beyond the scope of this Article (Chapter); but contractual arrangements which as a business matter enter vitally

into the contract should be considered a part thereof insofar as cross-claims or defenses are concerned.

*Definitional Cross References:*

“Contract for sale”. Section 2-106 (A.C.A. § 4-2-106).

“Remedy”. Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-702 (A.C.A. § 4-2-702)\***

*Prior Uniform Statutory Provision:* Subsection (1) (A.C.A. § 4-2-702(1)) — Sections 53(1)(b), 54(1)(c) and 57, Uniform Sales Act; Subsection (2) (A.C.A. § 4-2-702(2)) — none; Subsection (3) (A.C.A. § 4-2-702(3)) — Section 76(3), Uniform Sales Act.

*Changes:* Rewritten, the protection given to a seller who has sold on credit and has delivered goods to the buyer immediately preceding his insolvency being extended.

*Purposes of Changes and New Matter:* To make it clear that:

1. The seller’s right to withhold the goods or to stop delivery except for cash when he discovers the buyer’s insolvency

is made explicit in subsection (1) (A.C.A. § 4-2-702(1)) regardless of the passage of title, and the concept of stoppage has been extended to include goods in the possession of any bailee who has not yet attorned to the buyer.

2. Subsection (2) (A.C.A. § 4-2-702(2)) takes as its base line the proposition that any receipt of goods on credit by an insolvent buyer amounts to a tacit business misrepresentation of solvency and therefore is fraudulent as against the particular seller. This Article (Chapter) makes discovery of the buyer’s insolvency and demand within a ten day period a condition of the right to reclaim goods on this ground. The ten day limitation period op-

erates from the time of receipt of the goods.

An exception to this time limitation is made when a written misrepresentation of solvency has been made to the particular seller within three months prior to the delivery. To fall within the exception the statement of solvency must be in writing, addressed to the particular seller and dated within three months of the delivery.

3. Because the right of the seller to reclaim goods under this section constitutes preferential treatment as against the buyer's other creditors, subsection (3) (A.C.A. § 4-2-702(3)) provides that such reclamation bars all of his other remedies as to the goods involved.

*Cross References:*

Point 1: Sections 2-401 (A.C.A. § 4-2-401) and 2-705 (A.C.A. § 4-2-705).

Compare Section 2-502 (A.C.A. § 4-2-502).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Buyer in ordinary course of business". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Insolvent". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

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\*The Arkansas version of this section was amended by Acts 1967, No. 303, § 4, to incorporate the 1966 changes to this section in the Uniform Commercial Code.

### Comment to § 2-703 (A.C.A. § 4-2-703)

*Prior Uniform Statutory Provision:* No comparable index section.

*Purposes:*

1. This section is an index section which gathers together in one convenient place all of the various remedies open to a seller for any breach by the buyer. This Article (Chapter) rejects any doctrine of election of remedy as a fundamental policy and thus the remedies are essentially cumulative in nature and include all of the available remedies for breach. Whether the pursuit of one remedy bars another depends entirely on the facts of the individual case.

2. The buyer's breach which occasions the use of the remedies under this section may involve only one lot or delivery of goods, or may involve all of the goods which are the subject matter of the particular contract. The right of the seller to pursue a remedy as to all the goods when the breach is as to only one or more lots is covered by the section on breach in installment contracts. The present section deals

only with the remedies available after the goods involved in the breach have been determined by that section.

3. In addition to the typical case of refusal to pay or default in payment, the language in the preamble, "fails to make a payment due," is intended to cover the dishonor of a check on due presentment, or the nonacceptance of a draft, and the failure to furnish an agreed letter of credit.

4. It should also be noted that this Act requires its remedies to be liberally administered and provides that any right or obligation which it declares is enforceable by action unless a different effect is specifically prescribed (Section 1-106 (A.C.A. § 4-1-106)).

*Cross References:*

Point 2: Section 2-612 (A.C.A. § 4-2-612).

Point 3: Section 2-325 (A.C.A. § 4-2-325).

Point 4: Section 1-106 (A.C.A. § 4-1-106).



*Definitional Cross References:*

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Cancellation". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### Comment to § 2-704 (A.C.A. § 4-2-704)

*Prior Uniform Statutory Provision:* Sections 63(3) and 64(4), Uniform Sales Act.

*Changes:* Rewritten, the seller's rights being broadened.

*Purposes of Changes:*

1. This section gives an aggrieved seller the right at the time of breach to identify to the contract any conforming finished goods, regardless of their resalability, and to use reasonable judgment as to completing unfinished goods. It thus makes the goods available for resale under the resale section, the seller's primary remedy, and in the special case in which resale is not practicable, allows the action for the price which would then be necessary to give the seller the value of his contract.

2. Under this Article (Chapter) the seller is given express power to complete manufacture or procurement of goods for the contract unless the exercise of reasonable commercial judgment as to the facts

as they appear at the time he learns of the breach makes it clear that such action will result in a material increase in damages. The burden is on the buyer to show the commercially unreasonable nature of the seller's action in completing manufacture.

*Cross References:*

Sections 2-703 (A.C.A. § 4-2-703) and 2-706 (A.C.A. § 4-2-706).

*Definitional Cross References:*

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Conforming". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### Comment to § 2-705 (A.C.A. § 4-2-705)

*Prior Uniform Statutory Provision:* Sections 57-59, Uniform Sales Act; See also Sections 12, 14 and 42, Uniform Bills of Lading Act and Sections 9, 11 and 49, Uniform Warehouse Receipts Act.

*Changes:* This section continues and develops the above sections of the Uniform Sales Act in the light of the other uniform statutory provisions noted.

*Purposes:* To make it clear that:

1. Subsection (1) (A.C.A. § 4-2-705(1)) applies the stoppage principle to other bailees as well as carriers.

It also expands the remedy to cover the situations, in addition to buyer's insolvency, specified in the subsection. But since stoppage is a burden in any case to carriers, and might be a very heavy burden to them if it covered all small ship-

ments in all these situations, the right to stop for reasons other than insolvency is limited to carload, truckload, planeload or larger shipments. The seller shipping to a buyer of doubtful credit can protect himself by shipping C.O.D.

Where stoppage occurs for insecurity it is merely a suspension of performance, and if assurances are duly forthcoming from the buyer the seller is not entitled to resell or divert.

Improper stoppage is a breach by the seller if it effectively interferes with the buyer's right to due tender under the section on manner of tender of delivery. However, if the bailee obeys an unjustified order to stop he may also be liable to the buyer. The measure of his obligation is dependent on the provisions of the Documents of Title Article (Chapter) (Section

7-303 (A.C.A. § 4-7-303)). Subsection (3)(b) (A.C.A. § 4-2-705(3)(b)) therefore gives him a right of indemnity as against the seller in such a case.

2. "Receipt by the buyer" includes receipt by the buyer's designated representative, the sub-purchaser, when shipment is made direct to him and the buyer himself never receives the goods. It is entirely proper under this Article (Chapter) that the seller, by making such direct shipment to the sub-purchaser, be regarded as acquiescing in the latter's purchase and as thus barred from stoppage of the goods as against him.

As between the buyer and the seller, the latter's right to stop the goods at any time until they reach the place of final delivery is recognized by this section.

Under subsection (3)(c) (A.C.A. § 4-2-705(3)(c)) and (d) (A.C.A. § 4-2-705(3)(d)), the carrier is under no duty to recognize the stop order of a person who is a stranger to the carrier's contract. But the seller's right as against the buyer to stop delivery remains, whether or not the carrier is obligated to recognize the stop order. If the carrier does obey it, the buyer cannot complain merely because of that circumstance; and the seller becomes obligated under subsection (3)(b) (A.C.A. § 4-2-705(3)(b)) to pay the carrier any ensuing damages or charges.

3. A diversion of a shipment is not a "reshipment" under subsection (2)(c) (A.C.A. § 4-2-705(2)(c)) when it is merely an incident to the original contract of transportation. Nor is the procurement of "exchange bills" of lading which change only the name of the consignee to that of the buyer's local agent but do not alter the destination of a reshipment.

Acknowledgment by the carrier as a "warehouseman" within the meaning of this Article (Chapter) requires a contract

of a truly different character from the original shipment, a contract not in extension of transit but as a warehouseman.

4. Subsection (3)(c) (A.C.A. § 4-2-705(3)(c)) makes the bailee's obedience of a notification to stop conditional upon the surrender of any outstanding negotiable document.

5. Any charges or losses incurred by the carrier in following the seller's orders, whether or not he was obligated to do so, fall to the seller's charge.

6. After an effective stoppage under this section the seller's rights in the goods are the same as if he had never made a delivery.

#### *Cross References:*

Sections 2-702 (A.C.A. § 4-2-702) and 2-703 (A.C.A. § 4-2-703).

Point 1: Sections 2-503 (A.C.A. § 4-2-503) and 2-609 (A.C.A. § 4-2-609), and Article 7 (Chapter 7).

Point 2: Section 2-103 (A.C.A. § 4-2-103) and Article 7 (Chapter 7).

#### *Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Insolvent". Section 1-201 (A.C.A. § 4-1-201).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### **Comment to § 2-706 (A.C.A. § 4-2-706)**

*Prior Uniform Statutory Provision:* Section 60, Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:* To simplify the prior statutory provision and to make it clear that:

1. The only condition precedent to the seller's right of resale under subsection (1)

(A.C.A. § 4-2-706(1)) is a breach by the buyer within the section on the seller's remedies in general or insolvency. Other meticulous conditions and restrictions of the prior uniform statutory provision are disapproved by this Article (Chapter) and are replaced by standards of commercial reasonableness. Under this section the seller may resell the goods after any



breach by the buyer. Thus, an anticipatory repudiation by the buyer gives rise to any of the seller's remedies for breach, and to the right of resale. This principle is supplemented by subsection (2) (A.C.A. § 4-2-706(2)) which authorizes a resale of goods which are not in existence or were not identified to the contract before the breach.

2. In order to recover the damages prescribed in subsection (1) (A.C.A. § 4-2-706(1)) the seller must act "in good faith and in a commercially reasonable manner" in making the resale. This standard is intended to be more comprehensive than that of "reasonable care and judgment" established by the prior uniform statutory provision. Failure to act properly under this section deprives the seller of the measure of damages here provided and relegates him to that provided in Section 2-708 (A.C.A. § 4-2-708).

Under this Article (Chapter) the seller resells by authority of law, in his own behalf, for his own benefit and for the purpose of fixing his damages. The theory of a seller's agency is thus rejected.

3. If the seller complies with the prescribed standard of duty in making the resale, he may recover from the buyer the damages provided for in subsection (1). Evidence of market or current prices at any particular time or place is relevant only on the question of whether the seller acted in a commercially reasonable manner in making the resale.

The distinction drawn by some courts between cases where the title had not passed to the buyer and the seller had resold as owner, and cases where the title had passed and the seller had resold by virtue of his lien on the goods, is rejected.

4. Subsection (2) (A.C.A. § 4-2-706(2)) frees the remedy of resale from legalistic restrictions and enables the seller to resell in accordance with reasonable commercial practices so as to realize as high a price as possible in the circumstances. By "public" sale is meant a sale by auction. A "private" sale may be effected by solicitation and negotiation conducted either directly or through a broker. In choosing between a public and private sale the character of the goods must be considered and relevant trade practices and usages must be observed.

5. Subsection (2) (A.C.A. § 4-2-706(2)) merely clarifies the common law rule that

the time for resale is a reasonable time after the buyer's breach, by using the language "commercially reasonable." What is such a reasonable time depends upon the nature of the goods, the condition of the market and the other circumstances of the case; its length cannot be measured by any legal yardstick or divided into degrees. Where a seller contemplating resale receives a demand from the buyer for inspection under the section of preserving evidence of goods in dispute, the time for resale may be appropriately lengthened.

On the question of the place for resale, subsection (2) (A.C.A. § 4-2-706(2)) goes to the ultimate test, the commercial reasonableness of the seller's choice as to the place for an advantageous resale. This Article (Chapter) rejects the theory that the seller is required to resell at the agreed place for delivery and that a resale elsewhere can be permitted only in exceptional cases.

6. The purpose of subsection (2) (A.C.A. § 4-2-706(2)) being to enable the seller to dispose of the goods to the best advantage, he is permitted in making the resale to depart from the terms and conditions of the original contract for sale to any extent "commercially reasonable" in the circumstances.

7. The provision of subsection (2) (A.C.A. § 4-2-706(2)) that the goods need not be in existence to be resold applies when the buyer is guilty of anticipatory repudiation of a contract for future goods, before the goods or some of them have come into existence. In such a case the seller may exercise the right of resale and fix his damages by "one or more contracts to sell" the quantity of conforming future goods affected by the repudiation. The companion provision of subsection (2) (A.C.A. § 4-2-706(2)) that resale may be made although the goods were not identified to the contract prior to the buyer's breach, likewise contemplates an anticipatory repudiation by the buyer but occurring after the goods are in existence. If the goods so identified conform to the contract, their resale will fix the seller's damages quite as satisfactorily as if they had been identified before the breach.

8. Where the resale is to be by private sale, subsection (3) (A.C.A. § 4-2-706(3)) requires that reasonable notification of the seller's intention to resell must be

given to the buyer. The length of notification of a private sale depends upon the urgency of the matter. Notification of the time and place of this type of sale is not required.

Subsection (4)(b) (A.C.A. § 4-2-706(4)(b)) requires that the seller give the buyer reasonable notice of the time and place of a public resale so that he may have an opportunity to bid or to secure the attendance of other bidders. An exception is made in the case of goods "which are perishable or threaten to decline speedily in value."

9. Since there would be no reasonable prospect of competitive bidding elsewhere, subsection (4) (A.C.A. § 4-2-706(4)) requires that a public resale "must be made at a usual place or market for public sale if one is reasonably available," i.e., a place or market which prospective bidders may reasonably be expected to attend. Such a market may still be "reasonably available" under this subsection, though at a considerable distance from the place where the goods are located. In such a case the expense of transporting the goods for resale is recoverable from the buyer as part of the seller's incidental damages under subsection (1) (A.C.A. § 4-2-706(1)). However, the question of availability is one of commercial reasonableness in the circumstances and if such "usual" place or market is not reasonably available, a duly advertised public resale may be held at another place if it is one which prospective bidders may reasonably be expected to attend, as distinguished from a place where there is no demand whatsoever for goods of the kind.

Paragraph (a) of subsection (4) (A.C.A. § 4-2-706(4)(a)) qualifies the last sentence of subsection (2) (A.C.A. § 4-2-706(2)) with respect to resales of unidentified and future goods at public sale. If conforming goods are in existence the seller may identify them to the contract after the buyer's breach and then resell them at public sale. If the goods have not been identified, however, he may resell them at public sale only as "future" goods and only where there is a recognized market for public sale of futures in goods of the kind.

The provisions of paragraph (c) of subsection (4) (A.C.A. § 4-2-706(4)(c)) are intended to permit intelligent bidding.

The provision of paragraph (d) of subsection (4) (A.C.A. § 4-2-706(4)(d)) per-

mitting the seller to bid and, of course, to become the purchaser, benefits the original buyer by tending to increase the resale price and thus decreasing the damages he will have to pay.

10. This Article (Chapter) departs in subsection (5) (A.C.A. § 4-2-706(5)) from the prior uniform statutory provision in permitting a good faith purchaser at resale to take a good title as against the buyer even though the seller fails to comply with the requirements of this section.

11. Under subsection (6) (A.C.A. § 4-2-706(6)), the seller retains profit, if any, without distinction based on whether or not he had a lien since this Article (Chapter) divorces the question of passage of title to the buyer from the seller's right of resale or the consequences of its exercise. On the other hand, where "a person in the position of a seller" or a buyer acting under the section on buyer's remedies, exercises his right of resale under the present section he does so only for the limited purpose of obtaining cash for his "security interest" in the goods. Once that purpose has been accomplished any excess in the resale price belongs to the seller to whom an accounting must be made as provided in the last sentence of subsection (6) (A.C.A. § 4-2-706(6)).

#### *Cross References:*

Point 1: Sections 2-610 (A.C.A. § 4-2-610), 2-702 (A.C.A. § 4-2-702) and 2-703 (A.C.A. § 4-2-703).

Point 2: Section 1-201 (A.C.A. § 4-1-201).

Point 3: Sections 2-708 (A.C.A. § 4-2-708) and 2-710 (A.C.A. § 4-2-710).

Point 4: Section 2-328 (A.C.A. § 4-2-328).

Point 8: Section 2-104 (A.C.A. § 4-2-104).

Point 9: Section 2-710 (A.C.A. § 4-2-710).

Point 11: Sections 2-401 (A.C.A. § 4-2-401), 2-707 (A.C.A. § 4-2-707) and 2-711(3) (A.C.A. § 4-2-711(3)).

#### *Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Good faith". Section 2-103 (A.C.A. § 4-2-103).



"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Merchant". Section 2-104 (A.C.A. § 4-2-104).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Person in position of seller". Section 2-707 (A.C.A. § 4-2-707).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Section 2-106 (A.C.A. § 4-2-106).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### Comment to § 2-707 (A.C.A. § 4-2-707)

*Prior Uniform Statutory Provision:* Section 52(2), Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:* To make it clear that:

In addition to following in general the prior uniform statutory provision, the case of a financing agency which has acquired documents by honoring a letter of credit for the buyer or by discounting a draft for the seller has been included in the term "a person in the position of a seller."

*Cross Reference:*

Article 5 (Chapter 5), Section 2-506 (A.C.A. § 4-2-506).

*Definitional Cross References:*

"Consignee". Section 7-102 (A.C.A. § 4-7-102).

"Consignor". Section 7-102 (A.C.A. § 4-7-102).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### Comment to § 2-708 (A.C.A. § 4-2-708)

*Prior Uniform Statutory Provision:* Section 64, Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:* To make it clear that:

1. The prior uniform statutory provision is followed generally in setting the current market price at the time and place for tender as the standard by which damages for non-acceptance are to be determined. The time and place of tender is determined by reference to the section on manner of tender of delivery, and to the sections on the effect of such terms as FOB, FAS, CIF, C & F, Ex Ship and No Arrival, No Sale.

In the event that there is no evidence available of the current market price at the time and place of tender, proof of a substitute market may be made under the section on determination and proof of market price. Furthermore, the section on the admissibility of market quotations is intended to ease materially the problem of providing competent evidence.

2. The provision of this section permit-

ing recovery of expected profit including reasonable overhead where the standard measure of damages is inadequate, together with the new requirement that price actions may be sustained only where resale is impractical, are designed to eliminate the unfair and economically wasteful results arising under the older law when fixed price articles were involved. This section permits the recovery of lost profits in all appropriate cases, which would include all standard priced goods. The normal measure there would be list price less cost to the dealer or list price less manufacturing cost to the manufacturer. It is not necessary to a recovery of "profit" to show a history of earnings, especially if a new venture is involved.

3. In all cases the seller may recover incidental damages.

*Cross References:*

Point 1: Sections 2-319 through 2-324 (A.C.A. §§ 4-2-319 through 4-2-324), 2-503 (A.C.A. § 4-2-503), 2-723 (A.C.A. § 4-2-723) and 2-724 (A.C.A. § 4-2-724).

Point 2: Section 2-709 (A.C.A. § 4-2-709).

Point 3: Section 2-710 (A.C.A. § 4-2-710).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-709 (A.C.A. § 4-2-709)**

*Prior Uniform Statutory Provision:* Section 63, Uniform Sales Act.

*Changes:* Rewritten, important commercially needed changes being incorporated.

*Purposes of Changes:* To make it clear that:

1. Neither the passing of title to the goods nor the appointment of a day certain for payment is now material to a price action.

2. The action for the price is now generally limited to those cases where resale of the goods is impracticable except where the buyer has accepted the goods or where they have been destroyed after risk of loss has passed to the buyer.

3. This section substitutes an objective test by action for the former "not readily resalable" standard. An action for the price under subsection (1)(b) (A.C.A. § 4-2-709(1)(b)) can be sustained only after a "reasonable effort to resell" the goods "at reasonable price" has actually been made or where the circumstances "reasonably indicate" that such an effort will be unavailing.

4. If a buyer is in default not with respect to the price, but on an obligation to make an advance, the seller should recover not under this section for the price as such, but for the default in the collateral (though coincident) obligation to finance the seller. If the agreement between the parties contemplates that the buyer will acquire, on making the advance, a security interest in the goods, the buyer on making the advance has such an interest as soon as the seller has rights in the agreed collateral. See Section 9-204 (A.C.A. § 4-9-204).

5. "Goods accepted" by the buyer under subsection (1)(a) (A.C.A. § 4-2-709(1)(a))

include only goods as to which there has been no justified revocation of acceptance, for such a revocation means that there has been a default by the seller which bars his rights under this section. "Goods lost or damaged" are covered by the section on risk of loss. "Goods identified to the contract" under subsection (1)(b) (A.C.A. § 4-2-709(1)(b)) are covered by the section on identification and the section on identification notwithstanding breach.

6. This section is intended to be exhaustive in its enumeration of cases where an action for the price lies.

7. If the action for the price fails, the seller may nonetheless have proved a case entitling him to damages for non-acceptance. In such a situation, subsection (3) (A.C.A. § 4-2-709(3)) permits recovery of those damages in the same action.

*Cross References:*

Point 4: Section 1-106 (A.C.A. § 4-1-106).

Point 5: Sections 2-501 (A.C.A. § 4-2-501), 2-509 (A.C.A. § 4-2-509), 2-510 (A.C.A. § 4-2-510) and 2-704 (A.C.A. § 4-2-704).

Point 7: Section 2-708 (A.C.A. § 4-2-708).

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conforming". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Seller". Section 2-103 (A.C.A. § 4-2-103).



**Comment to § 2-710 (A.C.A. § 4-2-710)**

*Prior Uniform Statutory Provision:* See Sections 64 and 70, Uniform Sales Act.

*Purposes:* To authorize reimbursement of the seller for expenses reasonably incurred by him as a result of the buyer's breach. The section sets forth the principal normal and necessary additional elements of damage flowing from the breach but intends to allow all commercially reasonable expenditures made by the seller.

*Definitional Cross References:*

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-711 (A.C.A. § 4-2-711)**

*Prior Uniform Statutory Provision:* No comparable index section; Subsection (3) (A.C.A. § 4-2-711(3)) — Section 69(5), Uniform Sales Act.

*Changes:* The prior uniform statutory provision is generally continued and expanded in Subsection (3) (A.C.A. § 4-2-711(3)).

*Purposes of Changes and New Matter:*

1. To index in this section the buyer's remedies, subsection (1) (A.C.A. § 4-2-711(1)) covering those remedies permitting the recovery of money damages, and subsection (2) (A.C.A. § 4-2-711(2)) covering those which permit reaching the goods themselves. The remedies listed here are those available to a buyer who has not accepted the goods or who has justifiably revoked his acceptance. The remedies available to a buyer with regard to goods finally accepted appear in the section dealing with breach in regard to accepted goods. The buyer's right to proceed as to all goods when the breach is as to only some of the goods is determined by the section on breach in installment contracts and by the section on partial acceptance.

Despite the seller's breach, proper tender of delivery under the section on cure of improper tender or replacement can effectively preclude the buyer's remedies under this section, except for any delay involved.

2. To make it clear in subsection (3) (A.C.A. § 4-2-711(3)) that the buyer may hold and resell rejected goods if he has paid a part of the price or incurred expenses of the type specified. "Paid" as used here includes acceptance of a draft or other time negotiable instrument or the

signing of a negotiable note. His freedom of resale is coextensive with that of a seller under this Article (Chapter) except that the buyer may not keep any profit resulting from the resale and is limited to retaining only the amount of the price paid and the costs involved in the inspection and handling of the goods. The buyer's security interest in the goods is intended to be limited to the items listed in subsection (3) (A.C.A. § 4-2-711(3)), and the buyer is not permitted to retain such funds as he might believe adequate for his damages. The buyer's right to cover, or to have damages for non-delivery, is not impaired by his exercise of his right of resale.

3. It should also be noted that this Act requires its remedies to be liberally administered and provides that any right or obligation which it declares is enforceable by action unless a different effect is specifically prescribed (Section 1-106 (A.C.A. § 4-1-106)).

*Cross References:*

Point 1: Sections 2-508 (A.C.A. § 4-2-508), 2-601(c) (A.C.A. § 4-2-601(c)), 2-608 (A.C.A. § 4-2-608), 2-612 (A.C.A. § 4-2-612) and 2-714 (A.C.A. § 4-2-714).

Point 2: Section 2-706 (A.C.A. § 4-2-706).

Point 3: Section 1-106 (A.C.A. § 4-1-106).

*Definitional Cross References:*

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Cancellation". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Cover". Section 2-712 (A.C.A. § 4-2-712).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### Comment to § 2-712 (A.C.A. § 4-2-712)

*Prior Uniform Statutory Provision:* None.

#### *Purposes:*

1. This section provides the buyer with a remedy aimed at enabling him to obtain the goods he needs thus meeting his essential need. This remedy is the buyer's equivalent of the seller's right to resell.

2. The definition of "cover" under subsection (1) (A.C.A. § 4-2-712(1)) envisages a series of contracts or sales, as well as a single contract or sale; goods not identical with those involved but commercially usable as reasonable substitutes under the circumstances of the particular case; and contracts on credit or delivery terms differing from the contract in breach, but again reasonable under the circumstances. The test of proper cover is whether at the time and place the buyer acted in good faith and in a reasonable manner, and it is immaterial that hindsight may later prove that the method of cover used was not the cheapest or most effective.

The requirement that the buyer must cover "without unreasonable delay" is not intended to limit the time necessary for him to look around and decide as to how he may best effect cover. The test here is similar to that generally used in this Article (Chapter) as to reasonable time and seasonable action.

3. Subsection (3) (A.C.A. § 4-2-712(3)) expresses the policy that cover is not a mandatory remedy for the buyer. The buyer is always free to choose between cover and damages for non-delivery under the next section.

However, this subsection must be read in conjunction with the section which limits the recovery of consequential damages to such as could not have been obviated by cover. Moreover, the operation of the section on specific performance of contracts

for "unique" goods must be considered in this connection for availability of the goods to the particular buyer for his particular needs is the test for that remedy and inability to cover is made an express condition to the right of the buyer to replevy the goods.

4. This section does not limit cover to merchants, in the first instance. It is the vital and important remedy for the consumer buyer as well. Both are free to use cover: the domestic or non-merchant consumer is required only to act in normal good faith while the merchant buyer must also observe all reasonable commercial standards of fair dealing in the trade, since this falls within the definition of good faith on his part.

#### *Cross References:*

Point 1: Section 2-706 (A.C.A. § 4-2-706).

Point 2: Section 1-204 (A.C.A. § 4-1-204).

Point 3: Sections 2-713 (A.C.A. § 4-2-713), 2-715 (A.C.A. § 4-2-715) and 2-716 (A.C.A. § 4-2-716).

Point 4: Section 1-203 (A.C.A. § 4-1-203).

#### *Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).



**Comment to § 2-713 (A.C.A. § 4-2-713)**

*Prior Uniform Statutory Provision:* Section 67(3), Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:* To clarify the former rule so that:

1. The general baseline adopted in this section uses as a yardstick the market in which the buyer would have obtained cover had he sought that relief. So the place for measuring damages is the place of tender (or the place of arrival if the goods are rejected or their acceptance is revoked after reaching their destination) and the crucial time is the time at which the buyer learns of the breach.

2. The market or current price to be used in comparison with the contract price under this section is the price for goods of the same kind and in the same branch of trade.

3. When the current market price under this section is difficult to prove the section on determination and proof of market price is available to permit a showing of a comparable market price or, where no market price is available, evidence of spot sale prices is proper. Where the unavailability of a market price is caused by a scarcity of goods of the type involved, a good case is normally made for specific performance under this Article

(Chapter). Such scarcity conditions, moreover, indicate that the price has risen and under the section providing for liberal administration of remedies, opinion evidence as to the value of the goods would be admissible in the absence of a market price and a liberal construction of allowable consequential damages should also result.

4. This section carries forward the standard rule that the buyer must deduct from his damages any expenses saved as a result of the breach.

5. The present section provides a remedy which is completely alternative to cover under the preceding section and applies only when and to the extent that the buyer has not covered.

*Cross References:*

Point 3: Sections 1-106 (A.C.A. § 4-1-106), 2-716 (A.C.A. § 4-2-716) and 2-723 (A.C.A. § 4-2-723).

Point 5: Section 2-712 (A.C.A. § 4-2-712).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-714 (A.C.A. § 4-2-714)**

*Prior Uniform Statutory Provision:* Section 69(6) and (7), Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes:*

1. This section deals with the remedies available to the buyer after the goods have been accepted and the time for revocation of acceptance has gone by. In general this section adopts the rule of the prior uniform statutory provision for measuring damages where there has been a breach of warranty as to goods accepted, but goes further to lay down an explicit provision as to the time and place for determining the loss.

The section on deduction of damages from price provides an additional remedy for a buyer who still owes part of the purchase price, and frequently the two

remedies will be available concurrently. The buyer's failure to notify of his claim under the section on effects of acceptance, however, operates to bar his remedies under either that section or the present section.

2. The "non-conformity" referred to in subsection (1) (A.C.A. § 4-2-714(1)) includes not only breaches of warranties but also any failure of the seller to perform according to his obligations under the contract. In the case of such non-conformity, the buyer is permitted to recover for his loss "in any manner which is reasonable."

3. Subsection (2) (A.C.A. § 4-2-714(2)) describes the usual, standard and reasonable method of ascertaining damages in the case of breach of warranty but it is not intended as an exclusive measure. It departs from the measure of damages for

non-delivery in utilizing the place of acceptance rather than the place of tender. In some cases the two may coincide, as where the buyer signifies his acceptance upon the tender. If, however, the non-conformity is such as would justify revocation of acceptance, the time and place of acceptance under this section is determined as of the buyer's decision not to revoke.

4. The incidental and consequential damages referred to in subsection (3), which will usually accompany an action brought under this section, are discussed in detail in the comment on the next section.

*Cross References:*

Point 1: Compare Section 2-711 (A.C.A. § 4-2-711); Sections 2-607 (A.C.A. § 4-2-607) and 2-717 (A.C.A. § 4-2-717).

Point 2: Section 2-106 (A.C.A. § 4-2-106).

Point 3: Sections 2-608 (A.C.A. § 4-2-608) and 2-713 (A.C.A. § 4-2-713).

Point 4: Section 2-715 (A.C.A. § 4-2-715).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conform". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 1-201 (A.C.A. § 4-1-201).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

**Comment to § 2-715 (A.C.A. § 4-2-715)**

*Prior Uniform Statutory Provision:* Subsection (2)(b) (A.C.A. § 4-2-715(2)(b)), Sections 69(7) and 70, Uniform Sales Act.

*Changes:* Rewritten.

*Purposes of Changes and New Matter:*

1. Subsection (1) (A.C.A. § 4-2-715(1)) is intended to provide reimbursement for the buyer who incurs reasonable expenses in connection with the handling of rightfully rejected goods or goods whose acceptance may be justifiably revoked, or in connection with effecting cover where the breach of the contract lies in non-conformity or non-delivery of the goods. The incidental damages listed are not intended to be exhaustive but are merely illustrative of the typical kinds of incidental damage.

2. Subsection (2) (A.C.A. § 4-2-715(2)) operates to allow the buyer, in an appropriate case, any consequential damages which are the result of the seller's breach. The "tacit agreement" test for the recovery of consequential damages is rejected. Although the older rule at common law which made the seller liable for all consequential damages of which he had "reason to know" in advance is followed, the liberality of that rule is modified by refusing to permit recovery unless the buyer could not reasonably have prevented the loss by cover or otherwise. Subparagraph (2) (A.C.A. § 4-2-715(2)) carries forward the

provisions of the prior uniform statutory provision as to consequential damages resulting from breach of warranty, but modifies the rule by requiring first that the buyer attempt to minimize his damages in good faith, either by cover or otherwise.

3. In the absence of excuse under the section on merchant's excuse by failure of presupposed conditions, the seller is liable for consequential damages in all cases where he had reason to know of the buyer's general or particular requirements at the time of contracting. It is not necessary that there be a conscious acceptance of an insurer's liability on the seller's part, nor is his obligation for consequential damages limited to cases in which he fails to use due effort in good faith.

Particular needs of the buyer must generally be made known to the seller while general needs must rarely be made known to charge the seller with knowledge.

Any seller who does not wish to take the risk of consequential damages has available the section on contractual limitation of remedy.

4. The burden of proving the extent of loss incurred by way of consequential damage is on the buyer, but the section on liberal administration of remedies rejects any doctrine of certainty which requires almost mathematical precision in the proof of loss. Loss may be determined in



any manner which is reasonable under the circumstances.

5. Subsection (2)(b) (A.C.A. § 4-2-715(2)(b)) states the usual rule as to breach of warranty, allowing recovery for injuries "proximately" resulting from the breach. Where the injury involved follows the use of goods without discovery of the defect causing the damage, the question of "proximate" cause turns on whether it was reasonable for the buyer to use the goods without such inspection as would have revealed the defects. If it was not reasonable for him to do so, or if he did in fact discover the defect prior to his use, the injury would not proximately result from the breach of warranty.

6. In the case of sale of wares to one in the business of reselling them, resale is one of the requirements of which the seller has reason to know within the meaning of subsection (2)(a) (A.C.A. § 4-2-715(2)(a)).

#### **Comment to § 2-716 (A.C.A. § 4-2-716)**

*Prior Uniform Statutory Provision:* Section 68, Uniform Sales Act.

*Changes:* Rephrased.

*Purposes of Changes:* To make it clear that:

1. The present section continues in general prior policy as to specific performance and injunction against breach. However, without intending to impair in any way the exercise of the court's sound discretion in the matter, this Article (Chapter) seeks to further a more liberal attitude than some courts have shown in connection with the specific performance of contracts of sale.

2. In view of this Article's (Chapter's) emphasis on the commercial feasibility of replacement, a new concept of what are "unique" goods is introduced under this section. Specific performance is no longer limited to goods which are already specific or ascertained at the time of contracting. The test of uniqueness under this section must be made in terms of the total situation which characterizes the contract. Output and requirements contracts involving a particular or peculiarly available source or market present today the typical commercial specific performance situation, as contrasted with contracts for the sale of heirlooms or priceless works of

#### *Cross References:*

Point 1: Section 2-608 (A.C.A. § 4-2-608).

Point 3: Sections 1-203 (A.C.A. § 4-1-203), 2-615 (A.C.A. § 4-2-615) and 2-719 (A.C.A. § 4-2-719).

Point 4: Section 1-106 (A.C.A. § 4-1-106).

#### *Definitional Cross References:*

"Cover". Section 2-712 (A.C.A. § 4-2-712).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

art which were usually involved in the older cases. However, uniqueness is not the sole basis of the remedy under this section for the relief may also be granted "in other proper circumstances" and inability to cover is strong evidence of "other proper circumstances".

3. The legal remedy of replevin is given the buyer in cases in which cover is reasonably unavailable and goods have been identified to the contract. This is in addition to the buyer's right to recover identified goods on the seller's insolvency (Section 2-502 (A.C.A. § 4-2-502)).

4. This section is intended to give the buyer rights to the goods comparable to the seller's rights to the price.

5. If a negotiable document of title is outstanding, the buyer's right of replevin relates of course to the document not directly to the goods. See Article 7 (Chapter 7), especially Section 7-602 (A.C.A. § 4-7-602).

#### *Cross References:*

Point 3: Section 2-502 (A.C.A. § 4-2-502).

Point 4: Section 2-709 (A.C.A. § 4-2-709).

Point 5: Article 7 (Chapter 7).

#### *Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-717 (A.C.A. § 4-2-717)**

*Prior Uniform Statutory Provision:* See Section 69(1)(a), Uniform Sales Act.

*Purposes:*

1. This section permits the buyer to deduct from the price damages resulting from any breach by the seller and does not limit the relief to cases of breach of warranty as did the prior uniform statutory provision. To bring this provision into application the breach involved must be of the same contract under which the price in question is claimed to have been earned.

2. The buyer, however, must give notice of his intention to withhold all or part of the price if he wishes to avoid a default

within the meaning of the section on insecurity and right to assurances. In conformity with the general policies of this Article (Chapter), no formality of notice is required and any language which reasonably indicates the buyer's reason for holding up his payment is sufficient.

*Cross Reference:*

Point 2: Section 2-609 (A.C.A. § 4-2-609).

*Definitional Cross References:*

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-718 (A.C.A. § 4-2-718)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Under subsection (1) (A.C.A. § 4-2-718(1)) liquidated damage clauses are allowed where the amount involved is reasonable in the light of the circumstances of the case. The subsection sets forth explicitly the elements to be considered in determining the reasonableness of a liquidated damage clause. A term fixing unreasonably large liquidated damages is expressly made void as a penalty. An unreasonably small amount would be subject to similar criticism and might be stricken under the section on unconscionable contracts or clauses.

2. Section (2) (A.C.A. § 4-2-718(2)) refuses to recognize a forfeiture unless the amount of the payment so forfeited represents a reasonable liquidation of damages as determined under subsection (1) (A.C.A. § 4-2-718(1)). A special exception is made in the case of small amounts (20% of the price or \$500, whichever is smaller) deposited as security. No distinction is made between cases in which the payment is to be applied on the price and those in which it is intended as security for performance. Subsection (2) (A.C.A. § 4-2-718(2)) is applicable to any deposit or down or part payment. In the case of a deposit or turn in of goods resold before

the breach, the amount actually received on the resale is to be viewed as the deposit rather than the amount allowed the buyer for the trade in. However, if the seller knows of the breach prior to the resale of the goods turned in, he must make reasonable efforts to realize their true value, and this is assured by requiring him to comply with the conditions laid down in the section on resale by an aggrieved seller.

*Cross References:*

Point 1: Section 2-302 (A.C.A. § 4-2-302).

Point 2: Section 2-706 (A.C.A. § 4-2-706).

*Definitional Cross References:*

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).



"Seller". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

### Comment to § 2-719 (A.C.A. § 4-2-719)

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Under this section parties are left free to shape their remedies to their particular requirements and reasonable agreements limiting or modifying remedies are to be given effect.

However, it is of the very essence of a sales contract that at least minimum adequate remedies be available. If the parties intend to conclude a contract for sale within this Article (Chapter) they must accept the legal consequence that there be at least a fair quantum of remedy for breach of the obligations or duties outlined in the contract. Thus any clause purporting to modify or limit the remedial provisions of this Article (Chapter) in an unconscionable manner is subject to deletion and in that event the remedies made available by this Article (Chapter) are applicable as if the stricken clause had never existed. Similarly, under subsection (2) (A.C.A. § 4-2-719(2)), where an apparently fair and reasonable clause because of circumstances fails in its purpose or operates to deprive either party of the substantial value of the bargain, it must give way to the general remedy provisions of this Article (Chapter).

2. Subsection (1)(b) (A.C.A. § 4-2-719(1)(b)) creates a presumption that clauses prescribing remedies are cumulative rather than exclusive. If the parties

intend the term to describe the sole remedy under the contract, this must be clearly expressed.

3. Subsection (3) (A.C.A. § 4-2-719(3)) recognizes the validity of clauses limiting or excluding consequential damages but makes it clear that they may not operate in an unconscionable manner. Actually such terms are merely an allocation of unknown or undeterminable risks. The seller in all cases is free to disclaim warranties in the manner provided in Section 2-316 (A.C.A. § 4-2-316).

*Cross References:*

Point 1: Section 2-302 (A.C.A. § 4-2-302).

Point 3: Section 2-316 (A.C.A. § 4-2-316).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Conforming". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Seller". Section 2-103 (A.C.A. § 4-2-103).

### Comment to § 2-720 (A.C.A. § 4-2-720)

*Prior Uniform Statutory Provision:* None.

*Purpose:*

This section is designed to safeguard a person holding a right of action from any unintentional loss of rights by the ill-advised use of such terms as "cancellation", "rescission", or the like. Once a party's rights have accrued they are not to be lightly impaired by concessions made in business decency and without intention to forego them. Therefore, unless the can-

cellation of a contract expressly declares that it is "without reservation of rights", or the like, it cannot be considered to be a renunciation under this section.

*Cross Reference:*

Section 1-107 (A.C.A. § 4-1-107).

*Definitional Cross References:*

"Cancellation". Section 2-106 (A.C.A. § 4-2-106).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-721 (A.C.A. § 4-2-721)**

*Prior Uniform Statutory Provision:* None.

*Purposes:* To correct the situation by which remedies for fraud have been more circumscribed than the more modern and mercantile remedies for breach of warranty. Thus the remedies for fraud are extended by this section to coincide in scope with those for non-fraudulent breach. This section thus makes it clear that neither rescission of the contract for fraud nor rejection of the goods bars other remedies unless the circumstances of the case make the remedies incompatible.

*Definitional Cross References:*

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 1-201 (A.C.A. § 4-1-201).\*

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

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\*"Goods" is actually defined in A.C.A. § 4-2-105 rather than in A.C.A. § 4-1-201 as listed in the Uniform Commercial Code section comment.

**Comment to § 2-722 (A.C.A. § 4-2-722)**

*Prior Uniform Statutory Provision:* None.

*Purposes:* To adopt and extend somewhat the principle of the statutes which provide for suit by the real party in interest. The provisions of this section apply only after identification of the goods. Prior to that time only the seller has a right of action. During the period between identification and final acceptance (except in the case of revocation of acceptance) it is possible for both parties to have the right of action. Even after final acceptance both parties may have the right of action if the seller retains possession or otherwise retains an interest.

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Buyer". Section 2-103 (A.C.A. § 4-2-103).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 2-723 (A.C.A. § 4-2-723)**

*Prior Uniform Statutory Provision:* None.

*Purposes:* To eliminate the most obvious difficulties arising in connection with the determination of market price, when that is stipulated as a measure of damages by some provision of this Article (Chapter). Where the appropriate market price is not readily available the court is here granted reasonable leeway in receiving evidence of prices current in other comparable markets or at other times comparable to the one in question. In accordance with the general principle of this Article (Chapter) against surprise, however, a party intending to offer evidence of such a substitute price must give suitable notice to the other party.

This section is not intended to exclude the use of any other reasonable method of

determining market price or of measuring damages if the circumstances of the case make this necessary.

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Usage of trade". Section 1-205 (A.C.A. § 4-1-205).



**Comment to § 2-724 (A.C.A. § 4-2-724)**

*Prior Uniform Statutory Provision:* None.

*Purposes:* To make market quotations admissible in evidence while providing for a challenge of the material by showing the circumstances of its preparation.

No explicit provision as to the weight to be given to market quotations is contained in this section, but such quotations, in the absence of compelling challenge, offer an adequate basis for a verdict.

Market quotations are made admissible when the price or value of goods traded "in any established market" is in issue. The reason of the section does not require that the market be closely organized in the manner of a produce exchange. It is sufficient if transactions in the commodity are frequent and open enough to make a mar-

ket established by usage in which one price can be expected to affect another and in which an informed report of the range and trend of prices can be assumed to be reasonably accurate.

This section does not in any way intend to limit or negate the application of similar rules of admissibility to other material, whether by action of the courts or by statute. The purpose of the present section is to assure a minimum of mercantile administration in this important situation and not to limit any liberalizing trend in modern law.

*Definitional Cross References:*

"Goods". Section 2-105 (A.C.A. § 4-2-105).

**Comment to § 2-725 (A.C.A. § 4-2-725)**

*Prior Uniform Statutory Provision:* None.

*Purposes:* To introduce a uniform statute of limitations for sales contracts, thus eliminating the jurisdictional variations and providing needed relief for concerns doing business on a nationwide scale whose contracts have heretofore been governed by several different periods of limitation depending upon the state in which the transaction occurred. This Article (Chapter) takes sales contracts out of the general laws limiting the time for commencing contractual actions and selects a four year period as the most appropriate to modern business practice. This is within the normal commercial record keeping period.

Subsection (1) (A.C.A. § 4-2-725(1)) permits the parties to reduce the period of limitation. The minimum period is set at one year. The parties may not, however, extend the statutory period.

Subsection (2) (A.C.A. § 4-2-725(2)), providing that the cause of action accrues when the breach occurs, states an exception where the warranty extends to future performance.

Subsection (3) (A.C.A. § 4-2-725(3)) states the saving provision included in many state statutes and permits an addi-

tional short period for bringing new actions, where suits begun within the four year period have been terminated so as to leave a remedy still available for the same breach.

Subsection (4) (A.C.A. § 4-2-725(4)) makes it clear that this Article (Chapter) does not purport to alter or modify in any respect the law on tolling of the Statute of Limitations as it now prevails in the various jurisdictions.

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Aggrieved party". Section 1-201 (A.C.A. § 4-1-201).

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Goods". Section 2-105 (A.C.A. § 4-2-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Termination". Section 2-106 (A.C.A. § 4-2-106).

## ARTICLE 2A

(A.C.A. § 4-2A-101 ET SEQ.)

### FOREWORD

Article 2A of the Uniform Commercial Code (§ 4-2A-101 et seq.), along with Conforming Amendments to Articles 1 and 9 (§ 4-1-101 et seq. and § 4-9-101 et seq.), is presented, upon the recommendation of the Permanent Editorial Board for the Uniform Commercial Code, by the National Conference for Commissioners on Uniform State Laws and the American Law Institute. It represents a major development in commercial law, addressing a type of business transaction, the leasing of personal property, that has long existed. Under present law, transactions of this type are governed partly by common law principles relating to personal property, partly by principles relating to real estate leases, and partly by reference to Articles 2 and 9 of the Uniform Commercial Code (§ 4-2-101 et seq. and § 4-9-101 et seq.), dealing with Sales and Secured Transactions respectively. The legal rules and concepts derived from these sources imperfectly fit a transaction that involves personal property rather than realty, and a lease rather than either a sale or a security interest as such. A statute directly addressing the personal property lease is therefore appropriate.

Such a statute has become especially appropriate with the exponential expansion of the number and scale of personal property lease transactions. Article 2A (§ 4-2A-101 et seq.) will apply to transactions involving billions of dollars annually. It will apply to consumer's rental of automobiles or do-it-yourself equipment, on the one hand, and to leases of such items as commercial aircraft (to the extent not preempted by federal law) and industrial machinery, on the other. The text recognizes the differences between consumer and business leasing, while resting upon concepts that apply generally to any personal property lease transactions.

The final product represents an important undertaking of the Conference and the Institute. It has proceeded, following

recommendations by the Conference's Study Committee in 1981, through preparation and review by the Conference's Drafting Committee first of a proposed free-standing Uniform Personal Property Leasing Act, which was approved by the Conference, and later of Article 2A (§ 4-2A-101 et seq.), which proceeded through the Permanent Editorial Board, the Executive Committee of the Conference, the Conference, and the Council of the Institute and the Annual Meeting of the members of the Institute. Carrying the text through these several stages has required coordination of somewhat different procedures, and continued patience and mutual forbearance. At the same time, the text has been subjected to analysis and criticism from many points of view and thereby steadily improved.

The resulting product borrows from both Articles 2 and 9 (§ 4-2-101 et seq. and § 4-9-101 et seq.). These existing Articles of the Uniform Commercial Code (§ 4-2-101 et seq.) have certain imperfections revealed by the long experience since their adoption. Article 2A (§ 4-2A-101 et seq.) cannot overcome those imperfections but seeks to minimize their significance as applied to leases. More fundamentally, there is important conceptual dissonance between Article 2 and Article 9 (§ 4-2-101 et seq. and § 4-9-101 et seq.). The formulation of Article 2A (§ 4-2A-101 et seq.) takes Articles 2 and 9 (§ 4-2-101 et seq. and § 4-9-101 et seq.) as they are for the time being and hence has required careful adjustment to this dissonance.

The drafting task has been complicated both as a matter of substance and as a matter of process. The Reporter, Ronald DeKoven, has been a master of substance and a steady and receptive principal in the process. We join with the Conference and the Institute in expressing our admiration and appreciation for his contribution to this important field of law.



**Official Comment to Section 2A-101 (A.C.A. § 4-2A-101)***Rationale for Codification:*

There are several reasons for codifying the law with respect to leases of goods. An analysis of the case law as it applies to leases of goods suggests at least three significant issues to be resolved by codification. First, what is a lease? It is necessary to define lease to determine whether a transaction creates a lease or a security interest disguised as a lease. If the transaction creates a security interest disguised as a lease, the lessor will be required to file a financing statement or take other action to perfect its interest in the goods against third parties. There is no such requirement with respect to leases. Yet the distinction between a lease and a security interest disguised as a lease is not clear. Second, will the lessor be deemed to have made warranties to the lessee? If the transaction is a sale the express and implied warranties of Article 2 of the Uniform Commercial Code (§ 4-2-101 et seq.) apply. However, the warranty law with respect to leases is uncertain. Third, what remedies are available to the lessor upon the lessee's default? If the transaction is a security interest disguised as a lease, the answer is stated in Part 5 (§ 4-9-501 et seq.) of the Article on Secured Transactions (Article 9) (§ 4-9-101 et seq.). There is no clear answer with respect to leases.

There are reasons to codify the law with respect to leases of goods in addition to those suggested by a review of the reported cases. The answer to this important question should not be limited to the issues raised in these cases. Is it not also proper to determine the remedies available to the lessee upon the lessor's default? It is, but that issue is not reached through a review of the reported cases. This is only one of the many issues presented in structuring, negotiating and documenting a lease of goods.

*Statutory Analogue:*

After it was decided to proceed with the codification project, the drafting committee of the National Conference of Commissioners on Uniform State Laws looked for a statutory analogue, gradually narrowing the focus to the Article on Sales (Article 2) (§ 4-2-101 et seq.) and the Article on Secured Transactions (Article 9) (§ 4-9-101 et seq.). A review of the literature with respect to the sale of goods reveals that

Article 2 (§ 4-2-101 et seq.) is predicated upon certain assumptions: Parties to the sales transaction frequently are without counsel; the agreement of the parties often is oral or evidenced by scant writings; obligations between the parties are bilateral; applicable law is influenced by the need to preserve freedom of contract. A review of the literature with respect to personal property security law reveals that Article 9 (§ 4-9-101 et seq.) is predicated upon very different assumptions: Parties to a secured transaction regularly are represented by counsel; the agreement of the parties frequently is reduced to a writing, extensive in scope; the obligation between the parties are essentially unilateral; and applicable law seriously limits freedom of contract.

The lease is closer in spirit and form to the sale of goods than to the creation of a security interest. While parties to a lease are sometimes represented by counsel and their agreement is often reduced to a writing, the obligations of the parties are bilateral and the common law of leasing is dominated by the need to preserve freedom of contract. Thus the drafting committee concluded that Article 2 (§ 4-2-101 et seq.) was the appropriate statutory analogue.

*Issues:* The drafting committee then identified and resolved several issues critical to codification:

*Scope:* The scope of the Article (§ 4-2A-101 et seq.) was limited to leases (Section 2A-102) (§ 4-2A-102). There was no need to included leases intended as security, i.e., security interests disguised as leases, as they are adequately treated in Article 9 (§ 4-9-101 et seq.). Further, even if leases intended as security were included, the need to preserve the distinction would remain, as policy suggests treatment significantly different from that accorded leases.

*Definition of Lease:* Lease was defined to exclude leases intended as security (Section 2A-103(1)(j)) (§ 4-2A-103(1)(j)). Given the litigation to date a revised definition of security interest was suggested for inclusion in the Act (§ 4-2A-101 et seq.). (Section 1-201(37)) (§ 4-1-201(37)). This revision sharpens the distinction between leases and security interests disguised as leases.

*Filing:* The lessor was not required to

file a financing statement against the lessee or take any other action to protect the lessor's interest in the goods (Section 2A-301) (§ 4-2A-301). The refined definition of security interest will more clearly signal the need to file to potential lessors of goods. Those lessors who are concerned will file a protective financing statement (Section 9-408) (§ 4-9-408).

**Warranties:** All of the express and implied warranties of the Article on Sales (Article 2) (§ 4-2-101 et seq.) were included (Sections 2A-210 through 2A-216) (§§ 4-2A-210 — 4-2A-216), revised to reflect differences in lease transactions. The lease of goods is sufficiently similar to the sale of goods to justify this decision. Further, many courts have reached the same decision.

**Certificate of Title Laws:** Many leasing transactions involve goods subject to certificate of title statutes. To avoid conflict with those statutes, this Article (§ 4-2A-101 et seq.) is subject to them (Section 2A-104(1)(a)) (§ 4-2A-104(1)(a)).

**Consumer Leases:** Many leasing transactions involve parties subject to consumer protection statutes or decisions. To avoid conflict with those laws this Article (§ 4-2A-101 et seq.) is subject to them to the extent provided in (Section 2A-104(1)(c) and (2)) (§ 4-2A-104(1)(c) and (2)). Further, certain consumer protections have been incorporated in the Article (§ 4-2A-101 et seq.).

**Finance Leases:** Certain leasing transactions substitute the supplier of the goods for the lessor as the party responsible to the lessee with respect to warranties and the like. The definition of finance lease (Section 2A-103 (1)(g)) (§ 4-2A-103(1)(g)) was developed to describe these transactions. Various sections of the Article (§ 4-2A-101 et seq.) implement the substitution of the supplier for the lessor, including Sections 2A-209 and 2A-407 (§§ 4-2A-209 and 4-2A-407). No attempt was made to fashion a special rule where the finance lessor is an affiliate of the supplier of goods; this is to be developed by the courts, case by case.

**Sale and Leaseback:** Sale and leaseback transactions are becoming increasingly common. A number of state statutes treat transactions where

possession is retained by the seller as fraudulent per se or prima facie fraudulent. That position is not in accord with modern practice and thus is changed by the Article (§ 4-2A-101 et seq.) "if the buyer bought for value and in good faith" (Section 2A-308(3)) (§ 4-2A-308(3)).

**Remedies:** The Article (§ 4-2A-101 et seq.) has not only provided for lessor's remedies upon default by the lessee (Sections 2A-523 through 2A-531) (§§ 4-2A-523 — 4-2A-531), but also for lessee's remedies upon default by the lessor (Sections 2A-508 through 2A-522) (§§ 4-2A-508 — 4-2A-522). This is a significant departure from Article 9 (§ 4-9-101 et seq.), which provides remedies only for the secured party upon default by the debtor. This difference is compelled by the bilateral nature of the obligations between the parties to a lease.

**Damages:** Many leasing transactions are predicated on the parties' ability to stipulate an appropriate measure of damages in the event of default. The rule with respect to sales of goods (Section 2-718) (§ 4-2-718) is not sufficiently flexible to accommodate this practice. Consistent with the common law emphasis upon freedom to contract, the Article (§ 4-2A-101 et seq.) has created a revised rule that allows greater flexibility with respect to leases of goods (Section 2A-504(1)) (§ 4-2A-504(1)).

#### *History:*

This Article (§ 4-2A-101 et seq.) is a revision of the Uniform Personal Property Leasing Act, which was approved by the National Conference of Commissioners on Uniform State Laws in August, 1985. However, it was believed that the subject matter of the Uniform Personal Property Leasing Act would be better treated as an article of this Act (§ 4-1-101 et seq.). Thus, although the Conference promulgated the Uniform Personal Property Leasing Act as a Uniform Law, activity was held in abeyance to allow time to restate the Uniform Personal Property Leasing Act as Article 2A (§ 4-2A-101 et seq.).

In August, 1986 the Conference approved and recommended this Article (§ 4-2A-101 et seq.) (including conforming amendments to Article 1 (§ 4-1-101 et



seq.) and Article 9 (§ 4-9-101 et seq.) for promulgation as an amendment to this Act (§ 4-1-101 et seq.). In December, 1986 the Council of the American Law Institute approved and recommended this Article (§ 4-2A-101 et seq.) (including conforming amendments to Article 1 (§ 4-1-101 et seq.) and Article 9 (§ 4-9-101 et seq.)), with official comments, for promulgation as an amendment to this Act (§ 4-1-101 et seq.). In March, 1987 the Permanent Editorial Board for the Uniform Commercial Code approved and recommended this Article (§ 4-2A-101 et seq.) (including conforming amendments to Article 1 (§ 4-1-101 et seq.) and Article 9 (§ 4-9-101 et seq.)), with official comments, for promulgation as an amendment to this Act (§ 4-1-101 et seq.). In May, 1987 the American Law Institute approved and recommended this Article (§ 4-2A-101 et seq.) (including conforming amendments to Article 1 (§ 4-1-101 et seq.) and Article 9 (§ 4-9-101 et seq.)), with official comments, for promulgation as an amendment to this Act (§ 4-1-101 et seq.). In August, 1987 the Conference confirmed its approval of the final text of this Article (§ 4-2A-101 et seq.).

Upon its initial promulgation, Article 2A (§ 4-2A-101 et seq.) was rapidly enacted in several states, was introduced in a number of other states, and underwent bar association, law revision commission and legislative study in still further states. In that process debate emerged, principally sparked by the study of Article 2A (§ 4-2A-101 et seq.) by the California Bar Association, California's non-uniform amendments to Article 2A (§ 4-2A-101 et seq.), and articles appearing in a symposium on Article 2A (§ 4-2A-101 et seq.) published after its promulgation in the Alabama Law Review. The debate chiefly centered on whether Article 2A (§ 4-2A-101 et seq.) had struck the proper balance or was clear enough concerning the ability of a lessor to grant a security interest in its leasehold interest and in the residual, priority between a secured party and the lessee, and the lessor's remedy structure under Article 2A (§ 4-2A-101 et seq.).

This debate over issues on which reasonable minds could and did differ began to affect the enactment effort for Article 2A (§ 4-2A-101 et seq.) in a deleterious manner. Consequently, the Standby Committee for Article 2A (§ 4-2A-101 et seq.),

composed predominantly of the former members of the drafting committee, reviewed the legislative actions and studies in the various states, and opened a dialogue with the principal proponents of the non-uniform amendments. Negotiations were conducted in conjunction with, and were facilitated by, a study of the uniform Article (§ 4-2A-101 et seq.) and the non-uniform Amendments by the New York Law Revision Commission. Ultimately, a consensus was reached, which has been approved by the membership of the Conference, the Permanent Editorial Board, and the Council of the Institute. Rapid and uniform enactment of Article 2A (§ 4-2A-101 et seq.) is expected as a result of the completed amendments. The Article 2A (§ 4-2A-101 et seq.) experience reaffirms the essential viability of the procedures of the Conference and the Institute for creating and updating uniform state law in the commercial law area.

*Relationship of Article 2A (§ 4-2A-101 et seq.) to Other Articles:*

The Article on Sales (§ 4-2-101 et seq.) provided a useful point of reference for codifying the law of leases. Many of the provisions of that Article (§ 4-2-101 et seq.) were carried over, changed to reflect differences in style, leasing terminology or leasing practices. Thus, the official comments to those sections of Article 2 (§ 4-2-101 et seq.) whose provisions were carried over are incorporated by reference in Article 2A (§ 4-2A-101 et seq.), as well; further, any case law interpreting those provisions should be viewed as persuasive but not binding on a court when deciding a similar issue with respect to leases. Any change in the sequence that has been made when carrying over a provision from Article 2 (§ 4-2-101 et seq.) should be viewed as a matter of style, not substance. This is not to suggest that in other instances Article 2A (§ 4-2A-101 et seq.) did not also incorporate substantially revised provisions of Article 2 (§ 4-2-101 et seq.), Article 9 (§ 4-9-101 et seq.) or otherwise where the revision was driven by a concern over the substance; but for the lack of a mandate, the drafting committee might well have made the same or a similar change in the statutory analogues. Those sections in Article 2A (§ 4-2A-101 et seq.) include Sections 2A-104, 2A-105, 2A-106, 2A-108(2) and (4), 2A-109(2), 2A-208, 2A-

214(2) and (3) (a), 2A-216, 2A-303, 2A-306, 2A-503, 2A-504(3)(b), 2A-506(2), and 2A-515 (§§ 4-2A-104 — 4-2A-106, 4-2A-108(2) and (4), 4-2A-109(2), 4-2A-208, 4-2A-214(2) and (3) (a), 4-2A-216, 4-2A-303, 4-2A-306, 4-2A-503, 4-2A-504(3)(b), 4-2A-506(2), and 4-2A-515). For lack of relevance or significance not all of the provisions of Article 2 (§ 4-2-101 et seq.) were incorporated in Article 2A (§ 4-2A-101 et seq.).

This codification was greatly influenced by the fundamental tenet of the common law as it has developed with respect to leases of goods: freedom of the parties to contract. Note that, like all other Articles of this Act (§ 4-1-101 et seq.), the principles of construction and interpretation contained in Article 1 (§ 4-1-101 et seq.) are applicable throughout Article 2A (§ 4-2A-101 et seq.) (Section 2A-103(4)) (§ 4-2A-103(4)). These principles include the

ability of the parties to vary the effect of the provisions of Article 2A (§ 4-2A-101 et seq.), subject to certain limitations including those that relate to the obligations of good faith, diligence, reasonableness and care (Section 1-102(3)) (§ 4-1-102 (3)). Consistent with those principles no negative inference is to be drawn by the episodic use of the phrase “unless otherwise agreed” in certain provisions of Article 2A (§ 4-2A-101 et seq.). Section 1-102(4) (§ 4-1-102(4)). Indeed, the contrary is true, as the general rule in the Act (§ 4-1-101 et seq.), including this Article (§ 4-2A-101 et seq.), is that the effect of the Act’s provisions may be varied by agreement. Section 1-102(3) (§ 4-1-102(3)). This conclusion follows even where the statutory analogue contains the phrase and the correlative provision in Article 2A (§ 4-2A-101 et seq.) does not.

#### Official Comment to Section 2A-102 (A.C.A. § 4-2A-102)

*Uniform Statutory Source:* Section 9-102(1) (§ 4-9-102(1)). Throughout this Article (§ 4-2A-101 et seq.), unless otherwise stated, references to “Section” are to other sections of this Act (§ 4-1-101 et seq.).

*Changes:* Substantially revised.

#### *Purposes:*

This Article (§ 4-2A-101 et seq.) governs transactions as diverse as the lease of a hand tool to an individual for a few hours and the leveraged lease of a complex line of industrial equipment to a multi-national organization for a number of years.

To achieve that end it was necessary to provide that this Article (§ 4-2A-101 et seq.) applies to any transaction, regardless of form, that creates a lease. Since lease is defined as a transfer of an interest in goods (Section 2A-103(1)(j)) (§ 4-2A-103(1)(j)) and goods is defined to include fixtures (Section 2A-103 (1) (h)) (§ 4-2A-103 (1) (h)), application is limited to the extent the transaction relates to goods, including fixtures. Further, since the definition of lease does not include a sale (Section 2-106(1)) (§ 4-2-106(1)) or retention or creation of a security interest (Section 1-201(37)) (§ 4-1-201(37)), application is further limited; sales and security

interests are governed by other Articles of this Act § 4-2-101 et seq. and § 4-9-101 et seq.).

Finally, in recognition of the diversity of the transactions to be governed, the sophistication of many of the parties to these transactions, and the common law tradition as it applies to the bailment for hire or lease, freedom of contract has been preserved. DeKoven, *Proceedings After Default by the Lessee Under a True Lease of Equipment*, in 1C P. Coogan, W. Hogan, D. Vagts, *Secured Transactions Under the Uniform Commercial Code*, § 29B.02(2) (1986). Thus, despite the extensive regulatory scheme established by this Article (§ 4-2A-101 et seq.), the parties to a lease will be able to create private rules to govern their transaction. Sections 2A-103(4) and 1-102(3) (§§ 4-2A-103(4) and 4-1-102(3)). However, there are special rules in this Article § 4-2A-101 et seq.) governing consumer leases, as well as other state and federal statutes, that may further limit freedom of contract with respect to consumer leases.

A court may apply this Article § 4-2A-101 et seq.) by analogy to any transaction, regardless of form, that creates a lease of personal property other than goods, taking into account the expressed intentions of the parties to the transaction and any



differences between a lease of goods and a lease of other property. Such application has precedent as the provisions of the Article on Sales (Article 2) (§ 4-2-101 et seq.) have been applied by analogy to leases of goods. E.G. Hawkland, *The Impact of the Uniform Commercial Code on Equipment Leasing*, 1972 Ill. L.F. 446; Murray, *Under the Spreading Analogy of Article 2 of the Uniform Commercial Code*, 39 Fordham L. Rev. 447 (1971). Whether such application would be appropriate for other bailments of personal property, gratuitous or for hire, should be determined by the facts of each case. See *Mieske v. Bartell Drug Co.*, 92 Wash. 2d 40, 46-48, 593 P.2d 1308, 1312 (1979).

Further, parties to a transaction creat-

ing a lease of personal property other than goods, or a bailment of personal property may provide by agreement that this Article (§ 4-2A-101 et seq.) applies. Upholding the parties' choice is consistent with the spirit of this Article § 4-2A-101 et seq.).

#### Cross References:

Sections 1-102(3), 1-201(37), Article 2, esp. Section 2-106(1), and Sections 2A-103(1)(h), 2A-103(1)(j) and 2A-103(4) (§§ 4-1-102(3), 4-1-201(37), 4-2-101 et seq., esp. 4-2-106(1), and §§ 4-2A-103(1)(h), 4-2A-103(1)(j) and 4-2A-103(4)).

#### Definitional Cross Reference:

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

### Official Comment to Section 2A-103 (A.C.A. § 4-2A-103)

(a) "Buyer in ordinary course of business". Section 1-201(9) (§ 4-1-201(9)).

(b) "Cancellation". Section 2-106(4) (§ 4-2-106(4)). The effect of a cancellation is provided in Section 2A-505(1) (§ 4-2A-505(1)).

(c) "Commercial unit". Section 2-105(6) (§ 4-2-105(6)).

(d) "Conforming". Section 2-106(2) (§ 4-2-106(2)).

(e) "Consumer lease". New. This Article (§ 4-2A-101 et seq.) includes a subset of rules that applies only to consumer leases. Sections 2A-106, 2A-108(2), 2A-108(4), 2A-109(2), 2A-221, 2A-309, 2A-406, 2A-407, 2A-504(3)(b), and 2A-516(3)(b) (§§ 4-2A-106, 4-2A-108(2) and (4), 4-2A-109(2), 4-2A-221, 4-2A-309, 4-2A-406, 4-2A-407, 4-2A-504(3)(b), and 4-2A-516(3)(b)).

For a transaction to qualify as a consumer lease it must first qualify as a lease. Section 2A-103(1)(j) (§ 4-2A-103(1)(j)). Note that this Article (§ 4-2A-101 et seq.) regulates the transactional elements of a lease, including a consumer lease; consumer protection statutes, present and future, and existing consumer protection decisions are unaffected by this Article § 4-2A-101 et seq.). Section 2A-104(1)(c) and (2) (§ 4-2A-104(1)(c) and (2)). Of course, Article 2A (§ 4-2A-101 et seq.) as state law also is subject to federal consumer protection law.

This definition is modeled after the definition of consumer lease in the Consumer Leasing Act, 15 U.S.C. § 1667 (1982), and

in the Unif. Consumer Credit Code § 1.301(14), 7A U.L.A. 43 (1974). However, this definition of consumer lease differs from its models in several respects: the lessor can be a person regularly engaged either in the business of leasing or of selling goods, the lease need not be for a term exceeding four months, a lease primarily for an agricultural purpose is not covered, and whether there should be a limitation by dollar amount and its amount is left up to the individual states.

This definition focuses on the parties as well as the transaction. If a lease is within this definition, the lessor must be regularly engaged in the business of leasing or selling, and the lessee must be an individual not an organization; note that a lease to two or more individuals having a common interest through marriage or the like is not excluded as a lease to an organization under Section 1-201(28) (§ 4-1-201(28)). The lessee must take the interest primarily for a personal, family or household purpose. If required by the enacting state, total payments under the lease contract, excluding payments for options to renew or buy, cannot exceed the figure designated.

(f) "Fault". Section 1-201(16) (§ 4-1-201(16)).

(g) "Finance Lease". New. This Article (§ 4-2A-101 et seq.) includes a subset of rules that applies only to finance leases. Sections 2A-209, 2A-211(2), 2A-212(1), 2A-213, 2A-219(1), 2A-220(1)(a), 2A-221,

2A-405(c), 2A-407, 2A-516(2) and 2A-517(1)(a) and (2) (§§ 4-2A-209, 4-2A-211(2), 4-2A-212(1), 4-2A-213, 4-2A-219(1), 4-2A-220(1)(a), 4-2A-221, 4-2A-405(c), 4-2A-407, 4-2A-516(2) and 4-2A-517(1)(a) and (2)).

For a transaction to qualify as a finance lease it must first qualify as a lease. Section 2A-103(1)(j) (4-2A-103(1)(j)). Unless the lessor is comfortable that the transaction will qualify as a finance lease, the lease agreement should include provisions giving the lessor the benefits created by the subset of rules applicable to the transaction that qualifies as a finance lease under this Article (§ 4-2A-101 et seq.).

A finance lease is the product of a three party transaction. The supplier manufactures or supplies the goods pursuant to the lessee's specification, perhaps even pursuant to a purchase order, sales agreement or lease agreement between the supplier and the lessee. After the prospective finance lease is negotiated, a purchase order, sales agreement, or lease agreement is entered into by the lessor (as buyer or prime lessee) or an existing order, agreement or lease is assigned by the lessee to the lessor, and the lessor and the lessee then enter into a lease or sublease of the goods. Due to the limited function usually performed by the lessor, the lessee looks almost entirely to the supplier for representations, covenants and warranties. If a manufacturer's warranty carries through, the lessee may also look to that. Yet, this definition does not restrict the lessor's function solely to the supply of funds; if the lessor undertakes or performs other functions, express warranties, covenants and the common law will protect the lessee.

This definition focuses on the transaction, not the status of the parties; to avoid confusion it is important to note that in other contexts, e.g., tax and accounting, the term finance lease has been used to connote different types of lease transactions, including leases that are disguised secured transactions. M. Rice, *Equipment Financing*, 62-71 (1981). A lessor who is a merchant with respect to goods of the kind subject to the lease may be a lessor under a finance lease. Many leases that are leases back to the seller of goods (Section 2A-308(3)) (§ 4-2A-308(3)) will be finance leases. This conclusion is easily demon-

strated by a hypothetical. Assume that B has bought goods from C pursuant to a sales contract. After delivery to and acceptance of the goods by B, B negotiates to sell the goods to A and simultaneously to lease the goods back from A, on terms and conditions that, we assume, will qualify the transaction as a lease. Section 2A-103(1)(j) (§ 4-2A-103(1)(j)). In documenting the sale and lease back, B assigns the original sales contract between B, as buyer, and C, as seller, to A. A review of these facts leads to the conclusion that the lease from A to B qualifies as a finance lease, as all three conditions of the definition are satisfied. Subparagraph (i) (§ 4-2A-103(1)(g)(i)) is satisfied as A, the lessor, had nothing to do with the selection, manufacture, or supply of the equipment. Subparagraph (ii) (§ 4-2A-103(1)(g)(ii)) is satisfied as A, the lessor, bought the equipment at the same time that A leased the equipment to B, which certainly is in connection with the lease. Finally, subparagraph (iii)(A) (§ 4-2A-103(1)(g)(iii)(A)) is satisfied as A entered into the sales contract with B at the same time that A leased the equipment back to B. B, the lessee, will have received a copy of the sales contract in a timely fashion.

Subsection (i) (§ 4-2A-103(1)(g)(i)) requires the lessor to remain outside the selection, manufacture and supply of the goods; that is the rationale for releasing the lessor from most of its traditional liability. The lessor is not prohibited from possession, maintenance or operation of the goods, as policy does not require such prohibition. To insure the lessee's reliance on the supplier, and not on the lessor, subsection (ii) (§ 4-2A-103(1)(g)(ii)) requires that the goods (where the lessor is the buyer of the goods) or that the right to possession and use of the goods (where the lessor is the prime lessee and the sublessor of the goods) be acquired in connection with the lease (or sublease) to qualify as a finance lease. The scope of the phrase "in connection with" is to be developed by the courts, case by case. Finally, as the lessee generally relies almost entirely upon the supplier for representations and covenants, and upon the supplier or a manufacturer, or both, for warranties with respect to the goods, subsection (iii) (§ 4-2A-103(1)(g)(iii)) requires that one of the following occur: (A) the lessee receive a copy of the supply contract before signing



the lease contract; (B) the lessee's approval of the supply contract is a condition to the effectiveness of the lease contract; (C) the lessee receive a statement describing the promises and warranties and any limitations relevant to the lessee before signing the lease contract; or (D) before signing the lease contract and except in a consumer lease, the lessee receive a writing identifying the supplier (unless the supplier was selected and required by the lessee) and the rights of the lessee under Section 2A-209 (§ 4-2A-209), and advising the lessee a statement of promises and warranties is available from the supplier. Thus, even where oral supply orders or computer placed supply orders are compelled by custom and usage the transaction may still qualify as a finance lease if the lessee approves the supply contract before the lease contract is effective and such approval was a condition to the effectiveness of the lease contract. Moreover, where the lessor does not want the lessee to see the entire supply contract, including price information, the lessee may be provided with a separate statement of the terms of the supply contract relevant to the lessee; promises between the supplier and the lessor that do not affect the lessee need not be included. The statement can be a restatement of those terms or a copy of portions of the supply contract with the relevant terms clearly designated. Any implied warranties need not be designated, but a disclaimer or modification of remedy must be designated. A copy of any manufacturer's warranty is sufficient if that is the warranty provided. However, a copy of any Regulation M disclosure given pursuant to 12 C.F.R. § 213.4(g) concerning warranties in itself is not sufficient since those disclosures need only briefly identify express warranties and need not include any disclaimer of warranty.

If a transaction does not qualify as a finance lease, the parties may achieve the same result by agreement; no negative implications are to be drawn if the transaction does not qualify. Further, absent the application of special rules (fraud, duress, and the like), a lease that qualifies as a finance lease and is assigned by the lessor or the lessee to a third party does not lose its status as a finance lease under this Article (§ 4-2A-101 et seq.). Finally, this Article (§ 4-2A-101 et seq.) creates no special rule where the lessor is an affiliate

of the supplier; whether the transaction qualifies as a finance lease will be determined by the facts of each case.

(h) "Goods". Section 9-105(1)(h) (§ 4-9-105(1)(h)). See Section 2A-103(3) (§ 4-2A-103(3)) for reference to the definition of "Account", "Chattel paper", "Document", "General intangibles" and "Instrument". See Section 2A-217 (§ 4-2A-217) for determination of the time and manner of identification.

(i) "Installment lease contract". Section 2-612(1) (§ 4-2-612(1)).

(j) "Lease". New. There are several reasons to codify the law with respect to leases of goods. An analysis of the case law as it applies to leases of goods suggests at least several significant issues to be resolved by codification. First and foremost is the definition of a lease. It is necessary to define lease to determine whether a transaction creates a lease or a security interest disguised as a lease. If the transaction creates a security interest disguised as a lease, the transaction will be governed by the Article on Secured Transactions (Article 9) (§ 4-9-101 et seq.) and the lessor will be required to file a financing statement or take other action to perfect its interest in the goods against third parties. There is no such requirement with respect to leases under the common law and, except with respect to leases of fixtures (Section 2A-309) (§ 4-2A-309)), this Article (§ 4-2A-101 et seq.) imposes no such requirement. Yet the distinction between a lease and a security interest disguised as a lease is not clear from the case law at the time of the promulgation of this Article (§ 4-2A-101 et seq.). DeKoven, *Leases of Equipment: Puritan Leasing Company v. August, A Dangerous Decision*, 12 U.S.F. L. Rev. 257 (1978).

At common law a lease of personal property is a bailment for hire. While there are several definitions of bailment for hire, all require a thing to be let and a price for the letting. Thus, in modern terms and as provided in this definition, a lease is created when the lessee agrees to furnish consideration for the right to the possession and use of goods over a specified period of time. Mooney, *Personal Property Leasing: A Challenge*, 36 Bus. Law. 1605, 1607 (1981). Further, a lease is neither a sale (Section 2-106(1)) (§ 4-2-106(1)) nor a retention or creation of a security interest (Section 1-201(37)) (§ 4-1-201(37)). Due to

extensive litigation to distinguish true leases from security interests, an amendment to Section 1-201(37) (§ 4-1-201(37)) has been promulgated with this Article (§ 4-2A-101 et seq.) to create a sharper distinction.

This section (§ 4-2A-103) as well as Section 1-201(37) (§ 4-1-201(37)) must be examined to determine whether the transaction in question creates a lease or a security interest. The following hypotheticals indicate the perimeters of the issue. Assume that A has purchased a number of copying machines, new, for \$1,000 each; the machines have an estimated useful economic life of three years. A advertises that the machines are available to rent for a minimum of one month and that the monthly rental is \$100.00. A intends to enter into leases where A provides all maintenance, without charge to the lessee. Further, the lessee will rent the machine, month to month, with no obligation to renew. At the end of the lease term the lessee will be obligated to return the machine to A's place of business. This transaction qualifies as a lease under the first half of the definition, for the transaction includes a transfer by A to a prospective lessee of possession and use of the machine for a stated term, month to month. The machines are goods (Section 2A-103(1)(h)) (§ 4-2A-103(1)(h)). The lessee is obligated to pay consideration in return, \$100.00 for each month of the term.

However, the second half of the definition provides that a sale or a security interest is not a lease. Since there is no passing of title, there is no sale. Sections 2A-103(3) and 2-106(1) (§§ 4-2A-103(3) and 4-2-106(1)). Under pre-Act security law this transaction would have created a bailment for hire or a true lease and not a conditional sale. *Da Rocha v. Macomber*, 330 Mass. 611, 614-15, 116 N.E.2d 139, 142 (1953). Under Section 1-201(37) (§ 4-1-201(37)), as amended with the promulgation of this Article (§ 4-2A-101 et seq.), the same result would follow. While the lessee is obligated to pay rent for the one month term of the lease, one of the other four conditions of the second paragraph of Section 1-201(37) (§ 4-1-201(37)) must be met and none is. The term of the lease is one month and the economic life of the machine is 36 months; thus, subparagraph (a) of Section 1-201(37) (§ 4-1-201(37) (a)) is not now satisfied. Consider-

ing the amount of the monthly rent, absent economic duress or coercion, the lessee is not bound either to renew the lease for the remaining economic life of the goods or to become the owner. If the lessee did lease the machine for 36 months, the lessee would have paid the lessor \$3,600 for a machine that could have been purchased for \$1,000; thus, subparagraph (b) of Section 1-201(37) (§ 4-1-201(37)(b)) is not satisfied. Finally, there are no options; thus, subparagraphs (c) and (d) of Section 1-201(37) (§ 4-1-201(37)(c) and (d)) are not satisfied. This transaction creates a lease, not a security interest. However, with each renewal of the lease the facts and circumstances at the time of each renewal must be examined to determine if that conclusion remains accurate, as it is possible that a transaction that first creates a lease, later creates a security interest.

Assume that the facts are changed and that A requires each lessee to lease the goods for 36 months, with no right to terminate. Under pre-Act security law this transaction would have created a conditional sale, and not a bailment for hire or true lease. *Hervey v. Rhode Island Locomotive Works*, 93 U.S. 664, 672-73 (1876). Under this subsection (§ 4-2A-103(1)(j)), and Section 1-201(37) (§ 4-1-201(37)), as amended with the inclusion of this Article (§ 4-2A-101 et seq.) in the Act (§ 4-1-101 et seq.), the same result would follow. The lessee's obligation for the term is not subject to termination by the lessee and the term is equal to the economic life of the machine.

Between these extremes there are many transactions that can be created. Some of the transactions have not been properly categorized by the courts in applying the 1978 and earlier Official Texts of Section 1-201(37). This subsection (§ 4-2A-103(1)(j)), together with Section 1-201(37) (§ 4-1-201(37)), as amended with the promulgation of this Article (§ 4-2A-101 et seq.), draws a brighter line, which should create a clearer signal to the professional lessor and lessee.

(k) "Lease agreement". This definition is derived from the first sentence of Section 1-201(3) (§ 4-1-201(3)). Because the definition of lease is broad enough to cover future transfers, lease agreement includes an agreement contemplating a current or subsequent transfer. Thus it was



not necessary to make an express reference to an agreement for the future lease of goods (Section 2-106(1)) (§ 4-2-106(1)). This concept is also incorporated in the definition of lease contract. Note that the definition of lease does not include transactions in ordinary building materials that are incorporated into an improvement on land. Section 2A-309(2) (§ 4-2A-309(2)).

The provisions of this Article (§ 4-2A-101 et seq.), if applicable, determine whether a lease agreement has legal consequences; otherwise the law of bailments and other applicable law determine the same. Sections 2A-103(4) and 1-103 (§§ 4-2A-103(4) and 4-1-103).

(l) "Lease contract". This definition is derived from the definition of contract in Section 1-201(11) (§ 4-1-201(11)). Note that a lease contract may be for the future lease of goods, since this notion is included in the definition of lease.

(m) "Leasehold interest". New.

(n) "Lessee". New.

(o) "Lessee in ordinary course of business". Section 1-201(9) (§ 4-1-201(9)).

(p) "Lessor". New.

(q) "Lessor's residual interest". New.

(r) "Lien". New. This term is used in Section 2A-307 (§ 4-2A-307) (Priority of Liens Arising by Attachment or Levy on, Security Interests in, and Other Claims to Goods).

(s) "Lot". Section 2-105(5) (§ 4-2-105(5)).

(t) "Merchant lessee". New. This term is used in Section 2A-511 (§ 4-2A-511) (Merchant Lessee's Duties as to Rightfully Rejected Goods). A person may satisfy the requirement of dealing in goods of the kind subject to the lease as lessor, lessee, seller, or buyer.

(u) "Present value". New. Authorities agree that present value should be used to determine fairly the damages payable by the lessor or the lessee on default. E.g.,

*Taylor v. Commercial Credit Equip. Corp.*, 170 Ga. App. 322, 316 S.E.2d 788 (Ct. App. 1984). Present value is defined to mean an amount that represents the discounted value as of a date certain of one or more sums payable in the future. This is a function of the economic principle that a dollar today is more valuable to the holder than a dollar payable in two years. While there is no question as to the principle, reasonable people would differ as to the rate of discount to apply in determining the value of that future dollar today. To minimize litigation, this Article (§ 4-2A-101 et seq.) allows the parties to specify the discount or interest rate, if the rate was not manifestly unreasonable at the time the transaction was entered into. In all other cases, the interest rate will be a commercially reasonable rate that takes into account the facts and circumstances of each case, as of the time the transaction was entered into.

(v) "Purchase". Section 1-201(32) (§ 4-1-201(32)). This definition omits the reference to lien contained in the definition of purchase in Article I (Section 1-201(32) (§ 4-1-201(32))). This should not be construed to exclude consensual liens from the definition of purchase in this Article (§ 4-2A-101 et seq.); the exclusion was mandated by the scope of the definition of lien in Section 2A-103(1)(r) (§ 4-2A-103(1)(r)). Further, the definition of purchaser in this Article (§ 4-2A-101 et seq.) adds a reference to lease; as purchase is defined in Section 1-201(32) (§ 4-1-201(32)) to include any other voluntary transaction creating an interest in property, this addition is not substantive.

(w) "Sublease". New.

(x) "Supplier". New.

(y) "Supply contract". New.

(z) "Termination". Section 2-106(3) (§ 4-2-106(3)). The effect of a termination is provided in Section 2A-505(2) (§ 4-2A-505(2)).

### Official Comment to Section 2A-104 (A.C.A. § 4-2A-104)\*

*Uniform Statutory Source:* Sections 9-203(4) and 9-302(3)(b) and (c) (§§ 4-9-203(4) and 4-9-302(3)(b) and (c)).

*Changes:* Substantially revised.

*Purposes:*

1. This Article (§ 4-2A-101 et seq.) cre-

ates a comprehensive scheme for the regulation of transactions that create leases. Section 2A-102 (§ 4-2A-102). Thus, the Article (§ 4-2A-101 et seq.) supersedes all prior legislation dealing with leases, except to the extent set forth in this Section (§ 4-2A-104).

2. Subsection (1) (§ 4-2A-104(1)) states the general rule that a lease, although governed by the scheme of this Article (§ 4-2A-101 et seq.), also may be governed by certain other applicable laws. This may occur in the case of a consumer lease. Section 2A-103(1)(e) (§ 4-2A-103(1)(e)). Those laws may be state statutes existing prior to enactment of Article 2A (§ 4-2A-101 et seq.) or passed afterward. In this case, it is desirable for this Article (§ 4-2A-101 et seq.) to specify which statute controls. Or the law may be a pre-existing consumer protection decision. This Article (§ 4-2A-101 et seq.) preserves such decisions. Or the law may be a statute of the United States. Such a law controls without any statement in this Article (§ 4-2A-101 et seq.) under applicable principles of preemption.

An illustration of a statute of the United States that governs consumer leases is the Consumer Leasing Act, 15 U.S.C. §§ 1667-1667(e) (1982) and its implementing regulation, Regulation N, 12 C.F.R. § 213 (1986); the statute mandates disclosures of certain lease terms, delimits the liability of a lessee in leasing personal property, and regulates the advertising of lease terms. An illustration of a state statute that governs consumer leases and which if adopted in the enacting state prevails over this Article (§ 4-2A-101 et seq.) is the Unif. Consumer Credit Code, which includes many provisions similar to those of the Consumer Leasing Act, e.g. Unif. Consumer Credit Code §§ 3.202, 3.209, 3.401, 7A U.L.A. 108-09, 115, 125 (1974), as well as provisions in addition to those of the Consumer Leasing Act, e.g., Unif. Consumer Credit Code §§ 5.109-.111, 7A U.L.A. 171-76 (1974) (the right to cure a default). Such statutes may define consumer lease so as to govern transactions within and without the definition of consumer lease under this Article (§ 4-2A-101 et seq.).

3. Under subsection (2) (§ 4-2A-104(2)), subject to certain limited exclusions, in case of conflict statute or a decision described in subsection (1) (§ 4-2A-104(1)) prevails over this Article (§ 4-2A-101 et seq.). For example, a provision life Unif. Consumer Credit Code § 5.112, 7A

U.L.A. 176 (1974), limiting self-help repossession, prevails over Section 2A-525 (3) (§ 4-2A-525 (3)). A consumer protection decision rendered after the effective date of this Article (§ 4-2A-101 et seq.) may supplement its provisions. For example, in relation to Article 9 (§ 4-9-101 et seq.) a court might conclude that an acceleration clause may not be enforced against an individual debtor after late payments have been accepted unless a prior notice of default is given. To the extent the decision establishes a general principle applicable to transactions other than secured transactions, it may supplement Section 2A-502 (§ 4-2A-502).

4. Consumer protection in lease transactions is primarily left to other law. However, several provisions of this Article (§ 4-2A-101 et seq.) do contain special rules that may not be varied by agreement in the case of a consumer lease. E.g., Sections 2A-106, 2A-108, and 2A-109(2) (§§ 4-2A-106, 4-2A-108, and 4-2A-109(2)). Were that not so, the ability of the parties to govern their relationship by agreement together with the position of the lessor in a consumer lease too often could result in a one-sided lease agreement.

5. In construing this provision (§ 4-2A-104) the reference to statute should be deemed to include applicable regulations. A consumer protection decision is "final" on the effective date of this Article (§ 4-2A-101 et seq.) if it is not subject to appeal on that date or, if subject to appeal, is not later reversed on appeal. Of course, such a decision can be overruled by a later decision or superseded by a later statute.

#### *Cross References:*

Sections 2A-103(1) (e), 2A-106, 2A-108, 2A-109(2) and 2A-525(3) (§§ 4-2A-103(1)(e), 4-2A-106, 4-2A-108, 4-2A-109(2) and 4-2A-525(3)).

#### *Definitional Cross Reference:*

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

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\*The version of this section enacted by Arkansas differs from the uniform act.



**Official Comment to Section 2A-105 (A.C.A. § 4-2A-105)**

*Uniform Statutory Source:* Section 9-103(2) (a) and (b) (§ 4-9-103(2) (a) and (b)).

*Changes:* Substantially revised. The provisions of the last sentence of Section 9-103(2)(b) (§ 4-9-103(2)(b)) have not been incorporated as it is superfluous in this context. The provisions of Section 9-103(2) (d) (§ 4-9-103(2) (d)) have not been incorporated because the problems dealt with are adequately addressed by this section and Sections 2A-304(3) and 305(3) (§§ 4-2A-304(3) and 4-2A-305(3)).

*Purposes:* The new certificate referred to in (b) (§ 4-2A-105(b)) must be permanent, not temporary. Generally, the lessor or creditor whose interest is indicated on the most recently issued certificate of title will

prevail over interests indicated on certificates issued previously by other jurisdictions. This provision (§ 4-2A-105(b)) reflects a policy that it is reasonable to require holders of interests in goods covered by a certificate of title to police the goods or risk losing their interests when a new certificate of title is issued by another jurisdiction.

*Cross References:*

Sections 2A-304(3), 2A-305(3), 9-103(2)(b) and 9-103(2)(d) (§§ 4-2A-304(3), 4-2A-305(3), 4-9-103(2)(b) and 4-9-103(2)(d)).

*Definitional Cross Reference:*

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

**Official Comment to Section 2A-106 (A.C.A. § 4-2A-106)**

*Uniform Statutory Source:* Unif. Consumer Credit Code § 1.201(8), 7A U.L.A. 36 (1974).

*Changes:* Substantially revised.

*Purposes:*

There is a real danger that a lessor may induce a consumer lessee to agree that the applicable law will be a jurisdiction that has little effective consumer protection, or to agree that the applicable forum will be a forum that is inconvenient for the lessee in the event of litigation. As a result, this section (§ 4-2A-106) invalidates these choice of law or forum clauses, except where the law chosen is that of the state of the consumer's residence or where the goods will be kept, or the forum chosen is one that otherwise would have jurisdiction over the lessee.

Subsection (1) (§ 4-2A-106(1)) limits potentially abusive choice of law clauses in consumer leases. The 30-day rule in subsection (1) (§ 4-2A-106(1)) was suggested by Section 9-103(1) (c) (§ 4-9-103(1)(c)). This section (§ 4-2A-106) has no effect on choice of law clauses in leases that are not consumer leases. Such clauses would be governed by other law.

Subsection (2) (§ 4-2A-106(2)) prevents enforcement of potentially abusive jurisdictional consent clauses in consumer leases. By using the term judicial forum, this section (§ 4-2A-106) does not limit selection of a nonjudicial forum, such as arbitration. This section (§ 4-2A-106) has no effect on choice of forum clauses in leases that are not consumer leases; such clauses are, as a matter of current law, "prima facie valid". *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 10 (1972). Such clauses would be governed by other law, including the Model Choice of Forum Act (1968).

*Cross Reference:*

Section 9-103(1)(c) (§ 4-9-103(1)(c)).

*Definitional Cross References:*

"Consumer lease". Section 2A-103(1) (e) (§ 4-2A-103(1)(e)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Goods". Section 2A-103(1) (h) (§ 4-2A-103(1) (h)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

**Official Comment to Section 2A-107 (A.C.A. § 4-2A-107)**

*Uniform Statutory Source:* Section 1-107 (§ 4-1-107).

*Changes:* Revised to reflect leasing practices and terminology. This clause is used throughout the official comments to this Article (§ 4-2A-101 et seq.) to indicate the scope of change in the provisions of the Uniform Statutory Source included in the section; these changes range from one extreme, e.g., a significant difference in practice (a warranty as to merchantability is not implied in a finance lease (Section 2A-212)) (§ 4-2A-212) to the other extreme, e.g., a modest difference in style or terminology (the transaction governed is a lease not a sale (Section 2A-203)) (§ 4-2A-203).

*Cross References:*

Sections 2A-203 and 2A-212 (§§ 4-2A-203 and 4-2A-212).

*Definitional Cross References:*

"Aggrieved party". Section 1-201(2) (§ 4-1-201(2)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Signed". Section 1-201(39) (§ 4-1-201(39)).

"Written". Section 1-201(46) (§ 4-1-201(46)).

**Official Comment to Section 2A-108 (A.C.A. § 4-2A-108)**

*Uniform Statutory Source:* Section 2-302 (§ 4-2-302) and Unif. Consumer Credit Code § 5.108, 7A U.L.A. 167-69 (1974).

*Changes:* Subsection (1) (§ 4-2A-108(1)) is taken almost verbatim from the provisions of Section 2-302 (1) (§ 4-2-302 (1)). Subsection (2) (§ 4-2A-108(2)) is suggested by the provisions of Unif. Consumer Credit Code § 5.108(1), (2), 7A U.L.A. 167 (1974). Subsection (3) (§ 4-2A-108(3)), taken from the provisions of Section 2-302(2) (§ 4-2-302(2)), has been expanded to cover unconscionable conduct. Unif. Consumer Credit Code § 5.108(3), 7A U.L.A. 167 (1974). The provision for the award of attorney's fees to consumers, subsection (4) (§ 4-2A-108(4)), covers unconscionability under subsection (1) (§ 4-2A-108(1)) as well as (2) (§ 4-2A-108(2)). Subsection (4) (§ 4-2A-108(4)) is modeled on the provisions of Unif. Consumer Credit Code § 5.108(6), 7A U.L.A. 169 (1974).

*Purposes:*

Subsections (1) and (3) of this section (§ 4-2A-108(1) and (3)) apply the concept of unconscionability reflected in the provisions of Section 2-302 (§ 4-2-302) to leases. See *Dillman & Assocs. v. Capitol Leasing Co.*, 110 Ill. App. 3d 335, 342, 442 N.E.2d 311, 316 (App. Ct. 1982). Subsection (3) (§ 4-2A-108(3)) omits the adjective "commercial" found in subsection 2-302(2) (§ 4-2-302(2)) because subsection (3) (§ 4-2A-108(3)) is concerned with all

leases and the relevant standard of conduct is determined by the context.

The balance of the section (§ 4-2A-108) is modeled on the provisions of Unif. Consumer Credit Code § 5.108, 7A U.L.A. 167-69 (1974). Thus subsection (2) (§ 4-2A-108(2)) recognizes that a consumer lease or a clause in a consumer lease may not itself be unconscionable but that the agreement would never have been entered into if unconscionable means had not been employed to induce the consumer to agree. To make a statement to induce the consumer to lease the goods, in the expectation of invoking an integration clause in the lease to exclude the statement's admissibility in a subsequent dispute, may be unconscionable. Subsection (2) (§ 4-2A-108(2)) also provides a consumer remedy for unconscionable conduct, such as using or threatening to use force or violence, in the collection of a claim arising from a lease contract. These provisions are not exclusive. The remedies of this section (§ 4-2A-108) are in addition to remedies otherwise available for the same conduct under other law, for example, an action in tort for abusive debt collection or under another statute of this State for such conduct. The reference to appropriate relief in subsection (2) (§ 4-2A-108(2)) is intended to foster liberal administration of this remedy. Sections 2A-103(4) and 1-106(1) (§§ 4-2A-103(4) and 4-1-106(1)).



Subsection (4) (§ 4-2A-108(4)) authorizes an award of reasonable attorney's fees if the court finds unconscionability with respect to a consumer lease under subsections (1) or (2) (§ 4-2A-108(1) or (2)). Provision is also made for recovery by the party against whom the claim was made if the court does not find unconscionability and does find that the consumer knew the action to be groundless. Further, subsection (4) (b) (§ 4-2A-108(4) (b)) is independent of, and thus will not override, a term in the lease agreement that provides for the payment of attorney's fees.

*Cross Reference:*

Sections 1-106(1), 2-302 and 2A-103(4) (§§ 4-1-106(1), 4-2-302 and 4-2A-103(4)).

*Definitional Cross References:*

"Action". Section 1-201(1) (§ 4-1-201(1)).

"Consumer lease". Section 2A-103(1)(e) (§ 4-2A-103(1)(e)).

"Lease contract". Section 2A-103(1)(1) (§ 4-2A-103(1)(1)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

**Official Comment to Section 2A-109 (A.C.A. § 4-2A-109)\***

*Uniform Statutory Source:* Section 1-208 (§ 4-1-208) and Unif. Consumer Credit Code § 5.109(2), 7A U.L.A. 171 (1974).

*Purposes:*

Subsection (1) (§ 4-2A-109(1)) reflects modest changes in style to the provisions of the first sentence of Section 1-208 (§ 4-1-208).

Subsection (2) (§ 4-2A-109(2)), however, reflects a significant change in the provisions of the second sentence of Section 1-208 (§ 4-1-208) by creating a new rule with respect to a consumer lease. A lease provision allowing acceleration at the will of the lessor or when the lessor deems itself insecure is of critical importance to the lessee. In a consumer lease it is a provision that is not usually agreed to by the parties but is usually mandated by the lessor. Therefore, where its invocation depends not on specific criteria but on the discretion of the lessor, its use should be regulated to prevent abuse. Subsection (1)

(§ 4-2A-109(1)) imposes a duty of good faith upon its exercise. Subsection (2) (§ 4-2A-109(2)) shifts the burden of establishing good faith to the lessor in the case of a consumer lease, but not otherwise.

*Cross Reference:*

Section 1-208 (§ 4-1-208).

*Definitional Cross Reference:*

"Burden of establishing". Section 1-201(8) (§ 4-1-201(8)).

"Consumer lease". Section 2A-103(1)(e) (§ 4-2A-103(1)(e)).

"Good faith". Sections 1-201(19) and 2-103(1)(b) (§§ 4-1-201(19) and 4-2-103(1)(b)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Term". Section 1-201(42) (§ 4-1-201(42)).

\*The version of this section enacted by Arkansas differs from the uniform act.

**Official Comment to Section 2A-201 (A.C.A. § 4-2A-201)**

*Uniform Statutory Source:* Sections 2-201, 9-203(1) and 9-110 (§§ 4-2-201, 4-9-203(1) and 4-9-110).

*Changes:* This section is modeled on Section 2-201 (§ 4-2-201), with changes to reflect the differences between a lease contract and a contract for the sale of

goods. In particular, subsection (1)(b) (§ 4-2A-201(1)(b)) adds a requirement that the writing "describe the goods leased and the lease term", borrowing that concept, with revisions, from the provisions of Section 9-203(1)(a) (§ 4-9-203(1)(a)). Subsection (2) (§ 4-2A-201(2)), relying on the statutory analogue in Section 9-110 (§ 4-

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9-110), sets forth the minimum criterion for satisfying that requirement.

*Purposes:* The changes in this section (§ 4-2A-201) conform the provisions of Section 2-201 (§ 4-2-201) to custom and usage in lease transactions. Section 2-201(2) (§ 4-2-201(2)), stating a special rule between merchants, was not included in this section (§ 4-2A-201) as the number of such transactions involving leases, as opposed to sales, was thought to be modest. Subsection (4) (§ 4-2A-201(4)) creates no exception for transactions where payment has been made and accepted. This represents a departure from the analogue, Section 2-201(3)(c) (§ 4-2-201(3)(c)). The rationale for the departure is grounded in the distinction between sales and leases. Unlike a buyer in a sales transaction, the lessee does not tender payment in full for goods delivered, but only payment of rent for one or more months. It was decided that, as a matter of policy, this act of payment is not a sufficient substitute for the required memorandum. Subsection (5) (§ 4-2A-201(5)) was needed to establish the criteria for supplying the lease term if it is omitted, as the lease contract may still be enforceable under subsection (4) (§ 4-2A-201(4)).

*Cross Reference:*

Sections 2-201, 9-110 and 9-203(1)(a) (§§ 4-2-201, 4-9-110 and 4-9-203(1)(a))

*Definitional Cross References:*

“Action”. Section 1-201(1) (§ 4-1-201(1)).

“Agreed”. Section 1-201(3) (§ 4-1-201(3)).

“Buying”. Section 2A-103(1)(a) (§ 4-2A-103(1)(a)).

“Goods”. Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

“Lease”. Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

“Lease contract”. Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

“Lessee”. Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

“Lessor”. Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

“Notice”. Section 1-201(25) (§ 4-1-201(25)).

“Party”. Section 1-201(29) (§ 4-1-201(29)).

“Sale”. Section 2-106(1) (§ 4-2-106(1)).

“Signed”. Section 1-201(39) (§ 4-1-201(39)).

“Term”. Section 1-201(42) (§ 4-1-201(42)).

“Writing”. Section 1-201(46) (§ 4-1-201(46)).

**Official Comment to Section 2A-202 (A.C.A. § 4-2A-202)**

*Uniform Statutory Source:* Section 2-202 (§ 4-2-202).

*Definitional Cross References:*

“Agreement”. Section 1-201(3) (§ 4-1-201(3)).

“Course of dealing.” Section 1-205 (§ 4-1-205).

“Party”. Section 1-201(29) (§ 4-1-201(29)).

“Term”. Section 1-201(42) (§ 4-1-201(42)).

“Usage of trade”. Section 1-205 (§ 4-1-205).

“Writing”. Section 1-201(46) (§ 4-1-201(46)).

**Official Comment to Section 2A-203 (A.C.A. § 4-2A-203)**

*Uniform Statutory Source:* Section 2-203 (§ 4-2-203).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

“Lease contract”. Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

“Writing”. Section 1-201(46) (§ 4-1-201(46)).

**Official Comment to Section 2A-204 (A.C.A. § 4-2A-204)**

*Uniform Statutory Source:* Section 2-204 (§ 4-2-204).

*Changes:* Revised to reflect leasing practices and terminology.



*Definitional Cross References:*

"Agreement". Section 1-201(3) (§ 4-1-201(3)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Term". Section 1-201(42) (§ 4-1-201(42)).

**Official Comment to Section 2A-205 (A.C.A. § 4-2A-205)**

*Uniform Statutory Source:* Section 2-205 (§ 4-2-205).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Merchant". Section 2-104(1) (§ 4-2-104(1)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Signed". Section 1-201(39) (§ 4-1-201(39)).

"Term". Section 1-201(42) (§ 4-1-201(42)).

"Writing". Section 1-201(46) (§ 4-1-201(46)).

**Official Comment to Section 2A-206 (A.C.A. § 4-2A-206)**

*Uniform Statutory Source:* Section 2-206(1) (a) and (2) (§ 4-2-206(1) (a) and (2)).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Notifies". Section 1-201(26) (§ 4-1-201(26)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

**Official Comment to Section 2A-207 (A.C.A. § 4-2A-207)**

*Uniform Statutory Source:* Sections 2-208 and 1-205(4) (§§ 4-2-208 and 4-1-205(4)).

*Changes:* Revised to reflect leasing practices and terminology, except that subsection (2) (§ 4-2A-207(2)) was further revised to make the subsection parallel the provisions of Section 1-205(4) (§ 4-1-205(4)) by adding that course of dealing controls usage of trade.

*Purposes:* The section (§ 4-2A-207) should be read in conjunction with Section 2A-208 (§ 4-2A-208). In particular, although a specific term may control over course of performance as a matter of lease construction under subsection (2) (§ 4-2A-207(2)), subsection (3) (§ 4-2A-207(3)) allows the same course of dealing to show a waiver or modification, if Section 2A-208 (§ 4-2A-208) is satisfied.

*Cross References:*

Sections 1-205(4), 2-208 and 2A-208 (§§ 4-1-205(4), 4-2-208 and 4-2A-208).

*Definitional Cross References:*

"Course of dealing". Section 1-205 (§ 4-1-205).

"Knowledge". Section 1-201(25) (§ 4-1-201(25)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Term". Section 1-201(42) (§ 4-1-201(42)).

"Usage of trade". Section 1-205 (§ 4-1-205).

**Official Comment to Section 2A-208 (A.C.A. § 4-2A-208)**

*Uniform Statutory Source:* Section 2-209 (§ 4-2-209).

*Changes:* Revised to reflect leasing practices and terminology, except that the provisions of subsection 2-209(3) (§ 4-2-209(3)) were omitted.

*Purposes:* Section 2-209(3) (§ 4-2-209(3)) provides that "the requirements of the statute of frauds section of this Article (§ Section 2-201) (§ 4-2-201) must be satisfied if the contract as modified is within its provisions." This provision was not incorporated as it is unfair to allow an oral modification to make the entire lease contract unenforceable, e.g., if the modification takes it a few dollars over the dollar limit. At the same time, the problem could not be solved by providing that the lease contract would still be enforceable in its premodification state (if it then satisfied the statute of frauds) since in some cases that might be worse than no enforcement at all. Resolution of the issue is left to the courts based on the facts of each case.

*Cross References:*

Sections 2-201 and 2-209 (§§ 4-2-201 and 4-2-209).

*Definitional Cross References:*

"Agreement". Section 1-201(3) (§ 4-1-201(3)).

"Between merchants". Section 2-104(3) (§ 4-2-104(3)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(1) (§ 4-2A-103(1)(1)).

"Merchant". Section 2-104(1) (§ 4-2-104(1)).

"Notification". Section 1-201(26) (§ 4-1-201(26)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Signed". Section 1-201(39) (§ 4-1-201(39)).

"Term". Section 1-201(42) (§ 4-1-201(42)).

"Writing". Section 1-201(46) (§ 4-1-201(46)).

**Official Comment to Section 2A-209 (A.C.A. § 4-2A-209)**

*Uniform Statutory Source:* None.

*Changes:* This section (§ 4-2A-209) is modeled on Section 9-318 (§ 4-9-318), the Restatement (Second) of Contracts §§ 302-315 (1981), and leasing practices. See *Earman Oil Co. v. Burroughs Corp.*, 625 F.2d 1291, 1296-97 (5th Cir. 1980).

*Purposes:*

1. The function performed by the lessor in a finance lease is extremely limited. Section 2A-103(1)(g) (§ 4-2A-103(1)(g)). The lessee looks to the supplier of the goods for warranties and the like or, in some cases as to warranties, to the manufacturer if a warranty made by that person is passed on. That expectation is reflected in subsection (1) (§ 4-2A-209(1)), which is self-executing. As a matter of policy, the operation of this provision (§ 4-2A-209(1)) may not be excluded, modified or limited; however, an exclusion, modification, or limitation of any term of the supply contract or warranty, including any with respect to rights and remedies, and any defense or claim such as a statute of limitations, effective against the lessor

as the acquiring party under the supply contract, is also effective against the lessee as the beneficiary designated under this provision (§ 4-2A-209(1)). For example, the supplier is not precluded from excluding or modifying an express or implied warranty under a supply contract. Sections 2-312(2) and 2-316, or Section 2A-214 (§§ 4-2-312(2) and 4-2-316, or § 4-2A-214). Further, the supplier is not precluded from limiting the rights and remedies of the lessor and from liquidating damages. Sections 2-718 and 2-719 or Sections 2A-503 and 2A-504 (§§ 4-2-718 and 4-2-719 or §§ 4-2A-503 and 4-2A-504). If the supply contract excludes or modifies warranties, limits remedies, or liquidates damages with respect to the lessor, such provisions are enforceable against the lessee as beneficiary. Thus, only selective discrimination against the beneficiaries designated under this section (§ 4-2A-209) is precluded, i.e., exclusion of the supplier's liability to the lessee with respect to warranties made to the lessor. This section (§ 4-2A-209) does not affect the development of other law with respect to products liability.



2. Enforcement of this benefit is by action. Sections 2A-103(4) and 1-106(2) (§§ 4-2A-103(4) and 4-1-106(2)).

3. The benefit extended by these provisions is not without a price, as this Article (§ 4-2A-101 et seq.) also provides in the case of a finance lease that is not a consumer lease that the lessee's promises to the lessor under the lease contract become irrevocable and independent upon the lessee's acceptance of the goods. Section 2A-407 (§ 4-2A-407).

4. Subsection (2) (§ 4-2A-209(2)) limits the effect of subsection (1) (§ 4-2A-209(1)) on the supplier and the lessor by preserving, notwithstanding the transfer of the benefits of the supply contract to the lessee, all of the supplier's and the lessor's rights and obligations with respect to each other and others; it further absolves the lessee of any duties with respect to the supply contract that might have been inferred from the extension of the benefits thereof.

5. Subsections (2) and (3) (§ 4-2A-209(2) and (3)) also deal with difficult issues related to modification or rescission of the supply contract. Subsection (2) (§ 4-2A-209(2)) states a rule that determines the impact of the statutory extension of benefit contained in subsection (1) (§ 4-2A-209(1)) upon the relationship of the parties to the supply contract and, in a limited respect, upon the lessee. This statutory extension of benefit, like that contained in Sections 2A-216 and 2-318 (§§ 4-2A-216 and 4-2-318), is not a modification of the supply contract by the parties. Thus, subsection (3) (§ 4-2A-209(3)) states the rules that apply to a modification or rescission of the supply contract by the parties. Subsection (3) (§ 4-2A-209(3)) provides that a modification or rescission is not effective between the supplier and the lessee if, before the modification or rescission occurs, the supplier received notice that the lessee has entered into the finance lease. On the other hand, if the modification or rescission is effective, then to the extent of the modification or rescis-

sion of the benefit or warranty, the lessor by statutory dictate assumes an obligation to provide to the lessee that which the lessee would otherwise lose. For example, assume a reduction in an express warranty from four years to one year. No prejudice to the lessee may occur if the goods perform as agreed. If, however, there is a breach of the express warranty after one year and before four years pass, the lessor is liable. A remedy for any prejudice to the lessee because of the bifurcation of the lessee's recourse resulting from the action of the supplier and the lessor is left to resolution by the courts based on the facts of each case.

6. Subsection (4) (§ 4-2A-209(4)) makes it clear that the rights granted to the lessee by this section do not displace any rights the lessee otherwise may have against the supplier.

#### *Cross References:*

Sections 2A-103 (1)(g), 2A-407 and 9-318 (§§ 4-2A-103(1)(g), 4-2A-407 and 4-9-318).

#### *Definitional Cross References:*

"Action". Section 1-201(1) (§ 4-1-201(1)).

"Finance lease". Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

"Leasehold interest". Section 2A-103(1)(m) (§ 4-2A-103(1)(m)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notice". Section 1-201(25) (§ 4-1-201(25)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Supplier". Section 2A-103(1) (x) (§ 4-2A-103(1)(x)).

"Supply contract". Section 2A-103(1)(y) (§ 4-2A-103(1)(y)).

"Term". Section 1-201(42) (§ 4-1-201(42)).

### **Official Comment to Section 2A-210 (A.C.A. § 4-2A-210)**

*Uniform Statutory Source:* Section 2-313 (§ 4-2-313).

*Changes:* Revised to reflect leasing practices and terminology.

#### *Purposes:*

All of the express and implied warranties of the Article on Sales (Article 2) (§ 4-2-101 et seq.) are included in this Article (§ 4-2A-101 et seq.), revised to

reflect the differences between a sale of goods and a lease of goods. Sections 2A-210 through 2A-216 (§§ 4-2A-210 — 4-2A-216). The lease of goods is sufficiently similar to the sale of goods to justify this decision. Hawkland, *The Impact of the Uniform Commercial Code on Equipment Leasing*, 1972 Ill. L.F. 446, 459-60. Many state and federal courts have reached the same conclusion.

Value of the goods, as used in subsection (2) (§ 4-2A-210(2)), includes rental value.

*Cross References:*

Article 2, esp. Section 2-313, and Sec-

tions 2A-210 through 2A-216 (§ 4-2-101 et seq., esp. § 4-2-313, and §§ 4-2A-210 — 4-2A-216).

*Definitional Cross References:*

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

**Official Comment to Section 2A-211 (A.C.A. § 4-2A-211)**

*Uniform Statutory Source:* Section 2-312 (§ 4-2-312).

*Changes:* This section is modeled on the provisions of Section 2-312 (§ 4-2-312), with modifications to reflect the limited interest transferred by a lease contract and the total interest transferred by a sale. Section 2-312(2) (§ 4-2-312(2)), which is omitted here, is incorporated in Section 2A-214 (§ 4-2A-214). The warranty of quiet possession was abolished with respect to sales of goods. Section 2-312 (?) official comment 1. Section 2A-211(1) (§ 4-2A-211(1)) reinstates the warranty of quiet possession with respect to leases. Inherent in the nature of the limited interest transferred by the lease — the right to possession and use of the goods — is the need of the lessee for protection greater than that afforded to the buyer. Since the scope of the protection is limited to claims or interests that arose from acts or omissions of the lessor, the lessor will be in position to evaluate the potential cost, certainly a far better position than that enjoyed by the lessee. Further, to the extent the market will allow, the lessor can attempt to pass on the anticipated additional cost to the lessee in the guise of higher rent.

*Purposes:* General language was chosen for subsection (1) (§ 4-2A-211(1)) that expresses the essence of the lessee's expectation: with an exception for infringement and the like, no person holding a claim or interest that arose from an act or omission of the lessor will be able to interfere with the lessee's use and enjoyment of the

goods for the lease term. Subsection (2) (§ 4-2A-211(2)), like other similar provisions in later sections, excludes the finance lessor from extending this warranty; with few exceptions (Sections 2A-210 and 2A-211(1)) (§§ 4-2A-210 and 4-2A-211(1)), the lessee under a finance lease is to look to the supplier for warranties and the like or, in some cases as to warranties, to the manufacturer if a warranty made by that person is passed on. Subsections (2) and (3) (§ 4-2A-211(2) and (3)) are derived from Section 2-312(3) (§ 4-2-312(3)). These subsections, (§ 4-2A-211(2) and (3)), as well as the analogues, should be construed so that applicable principles of law and equity supplement their provisions. Sections 2A-103(4) and 1-103 (§§ 4-2A-103(4) and 4-1-103).

*Cross References:*

Sections 2-312, 2-312(1), 2-312(2), 2-312 official comment 1, 2A-210, 2A-211(1) and 2A-214 (§§ 4-2-312, 4-2-312(1), 4-2-312(2), 4-2-312 official comment 1, 4-2A-210, 4-2A-211(1), and 4-2A-214).

*Definitional Cross References:*

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Finance lease". Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).



"Leasehold interest". Section 2A-103(1)(m) (§ 4-2A-103(1)(m)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Merchant". Section 2-104(1) (§ 4-2-104(1)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Supplier". Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

### Official Comment to Section 2A-212 (A.C.A. § 4-2A-212)

*Uniform Statutory Source:* Section 2-314 (§ 4-2-314).

*Changes:* Revised to reflect leasing practices and terminology. *E.g.*, *Glenn Dick Equip. Co. v. Galey Constr. Inc.*, 97 Idaho 216, 225, 541 P.2d 1184, 1193 (1975) (implied warranty of merchantability (Article 2) (§ 4-2-101 et seq.) extends to lease transactions).

*Definitional Cross References:*

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Course of dealing". Section 1-205 (§ 4-1-205).

"Finance lease". Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

"Fungible". Section 1-201(17) (§ 4-1-201(17)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Merchant". Section 2-104(1) (§ 4-2-104(1)).

"Usage of trade". Section 1-205 (§ 4-1-205).

### Official Comment to Section 2A-213 (A.C.A. § 4-2A-213)

*Uniform Statutory Source:* Section 2-315 (§ 4-2-315).

*Changes:* Revised to reflect leasing practices and terminology. *E.g.*, *All-States Leasing Co. v. Bass*, 96 Idaho 873, 879, 538 P.2d 1177, 1183 (1975) (implied warranty of fitness for a particular purpose (Article 2) (§ 4-2-101 et seq.) extends to lease transactions).

*Definitional Cross References:*

"Finance lease". Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Knows". Section 1-201(25) (§ 4-1-201(25)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

### Official Comment to Section 2A-214 (A.C.A. § 4-2A-214)

*Uniform Statutory Source:* Sections 2-316 and 2-312(2) (§§ 4-2-316 and 4-2-312(2)).

*Changes:* Subsection (2) (§ 4-2A-214(2)) requires that a disclaimer of the warranty of merchantability be conspicuous and in writing as is the case for a disclaimer of the warranty of fitness; this is contrary to the rule stated in Section 2-316(2) (§ 4-2-316(2)) with respect to the disclaimer of the warranty of merchantability. This section also provides that to exclude or mod-

ify the implied warranty of merchantability, fitness or against interference or infringement the language must be in writing and conspicuous. There are, however, exceptions to the rule. *E.g.*, course of dealing, course of performance, or usage of trade may exclude or modify an implied warranty. Section 2A-214(3)(c) (§ 4-2A-214(3)(c)). The analogue of Section 2-312(2) (§ 4-2-312(2)) has been moved to subsection (4) (§ 4-2A-214(4)) of this sec-

tion for a more unified treatment of disclaimers; there is no policy with respect to leases of goods that would justify continuing certain distinctions found in the Article on Sales (Article 2) (§ 4-2-101 et seq.) regarding the treatment of the disclaimer of various warranties. *Compare* Sections 2-312(2) and 2-316(2) (§§ 4-2-312(2) and 4-2-316(2)). Finally, the example of a disclaimer of the implied warranty of fitness stated in subsection (2) (§ 4-2A-214(2)) differs from the analogue stated in Section 2-316(2) (§ 4-2-316(2)); this example should promote a better understanding of the effect of the disclaimer.

**Purposes:** These changes were made to reflect leasing practices. *E.g.*, *FMC Finance Corp. v. Murphree*, 632 F.2d 413, 418 (5th Cir. 1980) (disclaimer of implied warranty under lease transactions must be conspicuous and in writing). The omission of the provisions of Section 2-316(4) (§ 4-2-316(4)) was not substantive. Sections 2A-503 and 2A-504 (§§ 4-2A-503 and 4-2A-504).

**Cross Reference:**

Article 2, esp. Sections 2-312(2) and

2-316, and Sections 2A-503 and 2A-504 (§ 4-2-101 et seq., esp. §§ 4-2-312(2) and 4-2-316, and §§ 4-2A-503 and 4-2A-504).

**Definitional Cross References:**

"Conspicuous". Section 1-201(10) (§ 4-1-201(10)).

"Course of dealing". Section 1-205 (§ 4-1-205).

"Fault". Section 2A-103(1)(f) (§ 4-2A-103(1)(f)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Knows". Section 1-201(25) (§ 4-1-201(25)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Usage of trade". Section 1-205 (§ 4-1-205).

"Writing". Section 1-201(46) (§ 4-1-201(46)).

**Official Comment to Section 2A-215 (A.C.A. § 4-2A-215)**

**Uniform Statutory Source:** Section 2-317 (§ 4-2-317).

**Definitional Cross Reference:**

"Party". Section 1-201(29) (§ 4-1-201(29)).

**Official Comment to Section 2A-216 (A.C.A. § 4-2A-216)\***

**Uniform Statutory Source:** Section 2-318 (§ 4-2-318).

**Changes:** The provisions of Section 2-318 (§ 4-2-318) have been included in this section, modified in two respects: first, to reflect leasing practice, including the special practices of the lessor under a finance lease; second, to reflect and thus codify elements of the official comment to Section 2-318 (§ 4-2-318) with respect to the effect of disclaimers and limitations of remedies against third parties.

**Purposes:**

Alternative A is based on the 1962 version of Section 2-318 (§ 4-2-318) and is least favorable to the injured person as the doctrine of privity imposed by other law is abrogated to only a limited extent. Alternatives B and C are based on later

additions to Section 2-318 (§ 4-2-318) and are more favorable to the injured person. In determining which alternative to select, the state legislature should consider making its choice parallel to the choice it made with respect to Section 2-318 (§ 4-2-318), as interpreted by the courts.

The last sentence of each of Alternatives A, B and C does not preclude the lessor from excluding or modifying an express or implied warranty under a lease. Section 2A-214 (§ 4-2A-214). Further, that sentence does not preclude the lessor from limiting the rights and remedies of the lessee and from liquidating damages. Sections 2A-503 and 2A-504 (§§ 4-2A-503 and 4-2A-504). If the lease excludes or modifies warranties, limits remedies for breach, or liquidates damages with respect to the lessee, such provisions are-



enforceable against the beneficiaries designated under this section. However, this last sentence forbids selective discrimination against the beneficiaries designated under this section, *i.e.*, exclusion of the lessor's liability to the beneficiaries with respect to warranties made by the lessor to the lessee.

Other law, including the Article on Sales (Article 2) (§ 4-2-101 et seq.), may apply in determining the extent to which a warranty to or for the benefit of the lessor extends to the lessee and third parties. This is in part a function of whether the lessor has bought or leased the goods.

This Article (§ 4-2A-101 et seq.) does not purport to change the development of the relationship of the common law, with respect to products liability, including strict liability in tort (as restated in Restatement (Second) of Torts, 402A (1965)), to the provisions of this Act (5 4-1-101 et seq.). Compare *Cline v. Prowler Indus. of Maryland*, 418 A.2d 968 (Del. 1980) and

*Hawkins Constr. Co. v. Matthews Co.*, 190 Neb. 546, 209 N.W.2d 643 (1973) with *Dippel v. Sciano*, 37 Wis. 2d 443, 155 N.W.2d 55 (1967).

*Cross References:*

Article 2, esp. Section 2-318, and Sections 2A-214, 2A-503 and 2A-504 (§ 4-2-101 et seq., esp. § 4-2-318, and §§ 4-2A-214, 4-2A-503 and 4-2A-504).

*Definitional Cross References:*

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

\*Arkansas has enacted Alternative C.

**Official Comment to Section 2A-217 (A.C.A. § 4-2A-217)**

*Uniform Statutory Source:* Section 2-501 (5 4-2-501).

*Changes:* This section (§ 4-2A-217), together with Section 2A-218 (§ 4-2A-218), is derived from the provisions of Section 2-501 (§ 4-2-501), with changes to reflect lease terminology; however, this section (§ 4-2A-217) omits as irrelevant to leasing practice the treatment of special property.

*Purposes:* With respect to subsection (b) (§ 4-2A-217(b)) there is a certain amount of ambiguity in the reference to when goods are designated, *e.g.*, when the lessor is both selling and leasing goods to the same lessee/buyer and has marked goods for delivery but has not distinguished between those related to the lease contract and those related to the sales contract. As

in Section 2-501(1)(b) (§ 4-2-501(1)(b)), this issue has been left to be resolved by the courts, case by case.

*Cross References:*

Sections 2-501 and 2A-218 (§§ 4-2-501 and 4-2A-218).

*Definitional Cross References:*

"Agreement". Section 1-201(3) (§ 4-1-201(3)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

**Official Comment to Section 2A-218 (A.C.A. § 4-2A-218)\***

*Uniform Statutory Source:* Section 2-501 (§ 4-2-501).

*Changes:* This section (§ 4-2A-218), together with Section 2A-217 (§ 4-2A-217), is derived from the provisions of Section 2-501 (§ 4-2-501), with changes and addi-

tions to reflect leasing practices and terminology.

*Purposes:* Subsection (2) (§ 4-2A-218(2)) states a rule allowing substitution of goods by the lessor under certain circumstances, until default or insolvency of the

lessor, or until notification to the lessee that identification is final. Subsection (3) (§ 4-2A-218(3)) states a rule regarding the lessor's insurable interest that, by virtue of the difference between a sale and a lease, necessarily is different from the rule stated in Section 2-501(2) (§ 4-2-501(2)) regarding the seller's insurable interest. For this purpose the option to buy shall be deemed to have been exercised by the lessee when the resulting sale is closed, not when the lessee gives notice to the lessor. Further, subsection (5) (§ 4-2A-218(5)) is new and reflects the common practice of shifting the responsibility and cost of insuring the goods between the parties to the lease transaction.

*Cross References:*

Sections 2-501, 2-501(2) and 2A-217 (§§ 4-2-501, 4-2-501(2) and 4-2A-217).

*Definitional Cross References:*

"Agreement". Section 1-201(3) (§ 4-1-201(3)).

"Buying". Section 2A-103(1)(a) (§ 4-2A-103(1)(a)).

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Insolvent". Section 1-201(23) (§ 4-1-201(23)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notification". Section 1-201(26) (§ 4-1-201(26)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

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\*The version of this section enacted by Arkansas differs from the uniform act.

**Official Comment to Section 2A-219 (A.C.A. § 4-2A-219)**

*Uniform Statutory Source:* Section 2-509(1) through (3) (§ 4-2-509(1) — (3)).

*Changes:* Subsection (1) (§ 4-2A-219(1)) is new. The introduction to subsection (2) (§ 4-2A-219(2)) is new, but subparagraph (a) (§ 4-2A-219(2)(a)) incorporates the provisions of Section 2-509(1) (§ 4-2-509(1)); subparagraph (b) (§ 4-2A-219(2)(b)) incorporates the provisions of Section 2-509(2) (§ 4-2-509(2)) only in part, reflecting current practice in lease transactions.

*Purposes:* Subsection (1) (§ 4-2A-219(1)) states rules related to retention or passage of risk of loss consistent with current practice in lease transactions. The provisions of subsection (4) of Section 2-509 (§ 4-2-509(4)) are not incorporated as they are not necessary. This section (§ 4-2A-219) does not deal with responsibility for loss caused by the wrongful act of either the lessor or the lessee.

*Cross References:*

Sections 2-509(1), 2-509(2) and 2-509(4)

(§§ 4-2-509(1), 4-2-509(2) and 4-2-509(4)).

*Definitional Cross References:*

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Finance lease". Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Merchant". Section 2-104(1) (§ 4-2-104(1)).

"Receipt". Section 2-103(1)(c) (§ 4-2-103(1)(c)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Supplier". Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

**Official Comment to Section 2A-220 (A.C.A. § 4-2A-220)**

*Uniform Statutory Source:* Section 2-510 (§ 4-2-510).

*Changes:* Revised to reflect leasing practices and terminology. The rule in Section



(1)(b) (§ 4-2A-220(1)(b)) does not allow the lessee under a finance lease to treat the risk of loss as having remained with the supplier from the beginning. This is appropriate given the limited circumstances under which the lessee under a finance lease is allowed to revoke acceptance. Section 2A-517 (§ 4-2A-517) and Section 2A-516 (§ 4-2A-516) official comment.

*Definitional Cross References:*

“Conforming”. Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

“Delivery”. Section 1-201(14) (§ 4-1-201(14)).

“Finance lease”. Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

“Goods”. Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

“Lease contract”. Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

“Lessee”. Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

“Lessor”. Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

“Reasonable time”. Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

“Rights”. Section 1-201(36) (§ 4-1-201(36)).

“Supplier”. Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

**Official Comment to Section 2A-221 (A.C.A. § 4-2A-221)**

*Uniform Statutory Source:* Section 2-613 (§ 4-2-613).

*Changes:* Revised to reflect leasing practices and terminology.

*Purposes:* Due to the vagaries of determining the amount of due allowance (Section 2-613 (b)) (§ 4-2-613 (b)), no attempt was made in subsection (b) (§ 4-2A-221(b)) to treat a problem unique to lease contracts and installment sales contracts: determining how to recapture the allowance, e.g., application to the first or last rent payments or allocation, pro rata, to all rent payments.

*Cross References:*

Section 2-613 (§ 4-2-613).

*Definitional Cross References:*

“Conforming”. Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

“Consumer lease”. Section 2A-103(1)(e) (§ 4-2A-103(1)(e)).

“Delivery”. Section 1-201(14) (§ 4-1-201(14)).

“Fault”. Section 2A-103(1)(f) (§ 4-2A-103(1)(f)).

“Finance lease”. Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

“Goods”. Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

“Lease”. Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

“Lease agreement”. Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

“Lease contract”. Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

“Lessee”. Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

“Lessor”. Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

“Rights”. Section 1-201(36) (§ 4-1-201(36)).

“Supplier”. Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

**Official Comment to Section 2A-301 (A.C.A. § 4-2A-301)**

*Uniform Statutory Source:* Section 9-201 (§ 4-9-201).

*Changes:* The first sentence of Section 9-201 (§ 4-9-201) was incorporated, modified to reflect leasing terminology. The second sentence of Section 9-201 (§ 4-9-201) was eliminated as not relevant to leasing practices.

*Purposes:*

1. This section (§ 4-2A-301) estab-

lishes a general rule regarding the validity and enforceability of a lease contract. The lease contract is effective and enforceable between the parties and against third parties. Exceptions to this general rule arise where there is a specific rule to the contrary in this Article (§ 4-2A-101 et seq.). Enforceability is, thus, dependent upon the lease contract meeting the requirements of the Statute of Frauds provisions of Section 2A-201 (§ 4-2A-201).

Enforceability is also a function of the lease contract conforming to the principles of construction and interpretation contained in the Article on General Provisions (Article 1) (§ 4-1-101 et seq.). Section 2A-103(4) (§ 4-2A-103(4)).

2. The effectiveness or enforceability of the lease contract is not dependent upon the lease contract or any financing statement or the like being filed or recorded; however, the priority of the interest of a lessor of fixtures with respect to the interests of certain third parties in such fixtures is subject to the provisions of The Article on Secured Transactions (Article 9) (§ 4-9-101 et seq.). Section 2A-309 (§ 4-2A-309). Prior to the adoption of this Article (§ 4-2A-101 et seq.) filing or recording was not required with respect to leases, only leases intended as security. The definition of security interest, as amended concurrently with the adoption of this Article (§ 4-2A-101 et seq.), more clearly delineates leases and leases intended as security and thus signals the need to file. Section 1-207(37) (§ 4-1-207(37)). Those lessors who are concerned about whether the transaction creates a lease or a security interest will continue to file a protective financing statement. Section 9-408 (§ 4-9-408). Coogan, *Leasing and the Uniform Commercial Code, in Equipment Leasing-Leveraged Leasing* 681, 744-46 (2d ed. 1980).

### 3. Hypothetical:

(a) In construing this section (§ 4-2A-301) it is important to recognize its relationship to other sections in this Article (§ 4-2A-101 et seq.). This is best demonstrated by reference to a hypothetical. Assume that on February 1 A, a manufacturer of combines and other farm equipment, leased a fleet of six combines to B, a corporation engaged in the business of farming, for a 12 month term. Under the lease agreement between A and B, A agreed to defer B's payment of the first two months' rent to April 1. On March 1 B recognized that it would need only four combines and thus subleased two combines to C for an 11 month term.

(b) This hypothetical raises a number of issues that are answered by the sections contained in this part (§ 4-2A-301 et seq.). Since lease is defined to include sublease (Section 2A-103(1)(j) and (w)) (§ 4-2A-103(1)(j) and (w)), this section provides

that the prime lease between A and B and the sublease between B and C are enforceable in accordance with their terms, except as otherwise provided in this Article (§ 4-2A-101 et seq.); that exception, in this case, is one of considerable scope.

(c) The separation of ownership, which is in A, and possession, which is in B with respect to four combines and which is in C with respect to two combines, is not relevant. Section 2A-302 (§ 4-2A-302). A's interest in the six combines cannot be challenged simply because A parted with possession to B, who in turn parted with possession of some of the combines to C. Yet it is important to note that by the terms of Section 2A-302 (§ 4-2A-302) this conclusion is subject to change if otherwise provided in this Article (§ 4-2A-101 et seq.).

(d) B's entering the sublease with C raises an issue that is treated by this part (§ 4-2A-301 et seq.). In a dispute over the leased combines A may challenge B's right to sublease. The rule is permissive as to transfers of interests under a lease contract, including subleases. Section 2A-303(2) (§ 4-2A-303(2)). However, the rule has two significant qualifications. If the prime lease contract between A and B prohibits B from subleasing the combines, or makes such a sublease an event of default, Section 2A-303(2) (§ 4-2A-303(2)) applies; thus, while B's interest under the prime lease may be transferred under the sublease to C, A may have a remedy pursuant to Section 2A-303(5) (§ 4-2A-303(5)). Absent a prohibition or default provision in the prime lease contract A might be able to argue that the sublease to C materially increases A's risk; thus, while B's interest under the prime lease may be transferred under the sublease to C, A may have a remedy pursuant to Section 2A-303(5) (§ 4-2A-303(5)). Section 2A-303(5)(b)(ii) (§ 4-2A-303(5)(b)(ii)).

(e) Resolution of this issue is also a function of the section dealing with the sublease of goods by a prime lessee (Section 2A-305) (§ 4-2A-305). Subsection (1) of Section 2A-305 (§ 4-2A-305(1)), which is subject to the rules of Section 2A-303 (§ 4-2A-303) stated above, provides that C takes subject to the interest of A under the prime lease between A and B. However, there are two exceptions. First, if B is a merchant (Sections 2A-103(3) and



2-104(1)) (§§ 4-2A-103(3) and 4-2-104(1)) dealing in goods of that kind and C is a sublessee in the ordinary course of business (Sections 2A-103(1)(o) and 2A-103(1)(n)) (§§ 4-2A-103(1)(o) and 4-2A-103(1)(n)), C takes free of the prime lease between A and B. Second, if B has rejected the six combines under the prime lease with A, and B disposes of the goods by sublease to C, C takes free of the prime lease if C can establish good faith. Section 2A-511(4) (§ 4-2A-511(4)).

(f) If the facts of this hypothetical are expanded and we assume that the prime lease obligated B to maintain the combines, an additional issue may be presented. Prior to entering the sublease, B, in satisfaction of its maintenance covenant, brought the two combines that it desired to sublease to a local independent dealer of A's. The dealer did the requested work for B. C inspected the combines on the dealer's lot after the work was completed. C signed the sublease with B two days later. C, however, was prevented from taking delivery of the two combines as B refused to pay the dealer's invoice for the repairs. The dealer furnished the repair service to B in the ordinary course of the dealer's business. If under applicable law the dealer has a lien on repaired goods in the dealer's possession, the dealer's lien will take priority over B's and C's interest, and also should take priority over A's interest, depending upon the terms of the lease contract and the applicable law. Section 2A-306 (§ 4-2A-306).

(g) Now assume that C is in financial straits and one of C's creditors obtains a judgment against C. If the creditor levies on C's subleasehold interest in the two combines, who will prevail? Unless the levying creditor also holds a lien covered by Section 2A-306 (§ 4-2A-306), discussed above, the judgment creditor will take its interest subject to B's rights under the sublease and A's rights under the prime lease. Section 2A-307(1) (§ 4-2A-307(1)). The hypothetical becomes more complicated if we assume that B is in financial straits and B's creditor holds the judgment. Here the judgment creditor takes subject to the sublease unless the lien attached to the two combines before the sublease contract became enforceable. Section 2A-307(2)(a) (§ 4-2A-307(2)(a)). However, B's judgment creditor cannot prime A's interest in the goods because,

with respect to A, the judgment creditor is a creditor of B in its capacity as lessee under the prime lease between A and B. Thus, here the judgment creditor's interest is subject to the lease between A and B. Section 2A-307(1) (§ 4-2A-307(1)).

(h) Finally, assume that on April 1 B is unable to pay A the deferred rent then due under the prime lease, but that C is current in its payments under the sublease from B. What effect will B's default under the prime lease between A and B have on C's rights under the sublease between B and C? Section 2A-301 (§ 4-2A-301) provides that a lease contract is effective against the creditors of either party. Since a lease contract includes a sublease contract (Section 2A-103(1)(l)) (§ 4-2A-103(1)(l)), the sublease contract between B and C arguably could be enforceable against A, a prime lessor who has extended unsecured credit to B, the prime lessee/sublessor, if the sublease contract meets the requirements of Section 2A-201 (§ 4-2A-201). However, the rule stated in Section 2A-301 (§ 4-2A-301) is subject to other provisions in this Article (§ 4-2A-101 et seq.). Under Section 2A-305 (§ 4-2A-305), C, as sublessee, would take subject to the prime lease contract in most cases. Thus, B's default under the prime lease will in most cases lead to A's recovery of the goods from C. Section 2A-523 (§ 4-2A-523). A and C could provide otherwise by agreement. Section 2A-311 (§ 4-2A-311). C's recourse will be to assert a claim for damages against B. Sections 2A-211(1) and 2A-508 (§§ 4-2A-211(1) and 4-2A-508).

#### 4. Relationship Between Sections:

(a) As the analysis of the hypothetical demonstrates, Part 3 of the Article (§ 4-2A-301 et seq.) focuses on issues that relate to the enforceability of the lease contract (Sections 2A-301, 2A-302 and 2A-303) (§§ 4-2A-301, 4-2A-302 and 4-2A-303) and to the priority of various claims to the goods subject to the lease contract (Sections 2A-304, 2A-305, 2A-306, 2A-307, 2A-308, 2A-309, 2A-310, and 2A-311) (§§ 4-2A-304, 4-2A-305, 4-2A-306, 4-2A-307, 4-2A-308, 4-2A-309, 4-2A-310, and 4-2A-311).

(b) This section (§ 4-2A-301) states a general rule of enforceability, which is subject to specific rules to the contrary stated elsewhere in the Article (§ 4-2A-101 et seq.). Section 2A-302 (§ 4-2A-302)

negates any notion that the separation of title and possession is fraudulent as a rule of law. Finally, Section 2A-303 (§ 4-2A-303) states rules with respect to the transfer of the lessor's interest (as well as the residual interest in the goods) or the lessee's interest under the lease contract. Qualifications are imposed as a function of various issues, including whether the transfer is the creation or enforcement of a security interest or one that is material to the other party to the lease contract. In addition, a system of rules is created to deal with the rights and duties among assignor, assignee and the other party to the lease contract.

(c) Sections 2A-304 and 2A-305 (§§ 4-2A-304 and 4-2A-305) are twins that deal with good faith transferees of goods subject to the lease contract. Section 2A-304 (§ 4-2A-304) creates a set of rules with respect to transfers by the lessor of goods subject to a lease contract; the transferee considered is a subsequent lessee of the goods. The priority dispute covered here is between the subsequent lessee and the original lessee of the goods (or persons claiming through the original lessee). Section 2A-305 (§ 4-2A-305) creates a set of rules with respect to transfers by the lessee of goods subject to a lease contract; the transferees considered are buyers of the goods or sublessees of the goods. The priority dispute covered here is between the transferee and the lessor of the goods (or persons claiming through the lessor).

(d) Section 2A-306 (§ 4-2A-306) creates a rule with respect to priority disputes between holders of liens for services or materials furnished with respect to goods subject to a lease contract and the lessor or the lessee under that contract. Section 2A-307 (§ 4-2A-307) creates a rule with respect to priority disputes between the lessee and creditors of the lessor and priority disputes between the lessor and creditors of the lessee.

(e) Section 2A-308 (§ 4-2A-308) creates a series of rules relating to allegedly

fraudulent transfers and preferences. The most significant rule is that set forth in subsection (3) (§ 4-2A-308(3)) which validates sale-leaseback transactions if the buyer-lessor can establish that he or she bought for value and in good faith.

(f) Sections 2A-309 and 2A-310 (§§ 4-2A-309 and 4-2A-310) create a series of rules with respect to priority disputes between various third parties and a lessor of fixtures or accessions, respectively, with respect thereto.

(g) Finally, Section 2A-311 (§ 4-2A-311) allows parties to alter the statutory priorities by agreement.

#### *Cross References:*

Article 1, especially Section 1-201(37), and Sections 2-104(1), 2A-103(1)(j), 2A-103(1)(l), 2A-103(1)(n), 2A-103(1)(o) and 2A-103(1)(w), 2A-103(3), 2A-103(4), 2A-201, 2A-301 through 2A-303, 2A-303(2), 2A-303(5), 2A-304 through 2A-307, 2A-307(1), 2A-307(2)(a), 2A-308 through 2A-311, 2A-508, 2A-511(4); 2A-523, Article 9, especially Sections 9-201 and 9-408 (§ 4-1-101 et seq., especially § 4-1-201(37), and §§ 4-2-104(1), 4-2A-103(1)(j), 4-2A-103(1)(l), 4-2A-103(1)(n), 4-2A-103(1)(o) and 4-2A-103(1)(w), 4-2A-103(3), 4-2A-103(4), 4-2A-201, 4-2A-301 — 4-2A-303, 4-2A-303(2), 4-2A-303(5), 4-2A-304 — 4-2A-307, 4-2A-307(1), 4-2A-307(2)(a), 4-2A-308 — 4-2A-311, 4-2A-508, 4-2A-511(4), 4-2A-523, 4-9-101 et seq., especially §§ 4-9-201 and 4-9-408).

#### *Definitional Cross References:*

"Creditor". Section 1-201(12) (§ 4-1-201(12)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Purchaser". Section 1-201(33) (§ 4-1-201(33)).

"Term". Section 1-201(42) (§ 4-1-201(42)).

### **Official Comment to Section 2A-302 (A.C.A. § 4-2A-302)**

*Uniform Statutory Source:* Section 9-202 (§ 4-9-202).

*Changes:* Section 9-202 (§ 4-9-202) was modified to reflect leasing terminology and to clarify the law of leases with re-

spect to fraudulent conveyances or transfers.

*Purposes:* The separation of ownership and possession of goods between the lessor and the lessee (or a third party) has cre-



ated problems under certain fraudulent conveyance statutes. See, e.g., *In re Ludlum Enters.*, 510 F.2d 996 (5th Cir. 1975); *Suburbia Fed. Sav. & Loan Ass'n v. Bel-Air Conditioning Co.*, 385 So. 2d 1151 (Fla. Dist. Ct. App. 1980). This section (§ 4-2A-302) provides, among other things, that separation of ownership and possession per se does not affect the enforceability of the lease contract. Sections 2A-301 and 2A-308 (§§ 4-2A-301 and 4-2A-308).

#### *Cross References:*

Sections 2A-301, 2A-308 and 9-202 (§§ 4-2A-301, 4-2A-308 and 4-9-202).

#### *Definitional Cross References:*

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

### **Official Comment to Section 2A-303 (A.C.A. § 4-2A-303)**

*Uniform Statutory Source:* Sections 2-210 and 9-311 (§§ 4-2-210 and 4-9-311).

*Changes:* The provisions of Sections 2-210 and 9-311 (§§ 4-2-210 and 4-9-311) were incorporated in this section (§ 4-2A-303), with substantial modifications to reflect leasing terminology and practice and to harmonize the principles of the respective provisions, i.e. limitations on delegation of performance on the one hand and alienability of rights on the other. In addition, unlike Section 2-210 (§ 4-2-210) which deals only with voluntary transfers, this section (§ 4-2A-303) deals with involuntary as well as voluntary transfers. Moreover, the principle of Section 9-318(4) (§ 4-9-318(4)) denying effectiveness to contractual terms prohibiting assignments of receivables due and to become due also is implemented.

#### *Purposes:*

1. Subsection (2) (§ 4-2A-303(2)) states a rule, consistent with Section 9-311 (§ 4-9-311), that voluntary and involuntary transfers of an interest of a party under the lease contract or of the lessor's residual interest, including by way of the creation or enforcement of a security interest, are effective, notwithstanding a provision in the lease agreement prohibiting the transfer or making the transfer an event of default. Although the transfers are effective, the provision in the lease agreement is nevertheless enforceable, but only as provided in subsection (5) (§ 4-2A-303(5)). Under subsection (5) (§ 4-2A-303(5)) the prejudiced party is limited to the remedies on "default under the lease contract" in this Article (§ 4-2A-101 et seq.) and, except as limited by this Article (§ 4-2A-101 et seq.), as provided in the lease

agreement, if the transfer has been made an event of default. Section 2A-501(2) (§ 4-2A-501(2)). Usually, there will be a specific provision to this effect or a general provision making a breach of a covenant an event of defaults. In those cases where the transfer is prohibited, but not made an event of default, the prejudiced party may recover damages; or, if the damage remedy would be ineffective adequately to protect that party, the court can order cancellation of the lease contract or enjoin the transfer. This rule that such provisions generally are enforceable is subject to subsections (3) and (4) (§ 4-2A-303(3) and (4)), which make such provisions unenforceable in certain instances.

2. The first such instance is described in subsection (3) (§ 4-2A-303(3)). A provision in a lease agreement which prohibits the creation or enforcement of a security interest, including sales of lease contracts subject to Article 9 (§ 4-9-101 et seq.) (Sections 9-102(1)(b) and 9-104(f)) (§§ 4-9-102(1)(b) and 4-9-104(f)), or makes it an event of default is generally not enforceable, reflecting the policy of Section 9-318(4) (§ 4-9-318(4)). However, that policy gives way to the doctrine stated in Section 2-210(2) (§ 4-2-210(2)), which gives one party to a contract the right to protect itself against an actual delegation (but not just a provision under which delegation might later occur) of a material performance by the other party. Accordingly, such a provision in a lease agreement is enforceable when the transfer delegates a material performance. Generally, as expressly provided in subsection (6) (§ 4-2A-303(6)), a transfer for security is not a delegation of duties. However, inasmuch as the creation of a security

interest includes the sale of a lease contract, if there are then unperformed duties on the part of the lessor/seller, there could be a delegation of duties in the sale, and, if such a delegation actually takes place and is of a material performance, a provision in a lease agreement prohibiting it or making it an event of default would be enforceable, giving rise to the rights and remedies stated in subsection (5) (§ 4-2A-303 (5)). The statute does not define "material." The parties may set standards to determine its meaning. The term is intended to exclude delegations of matters such as accounting to a professional accountant and the performance of, as opposed to the responsibility for, maintenance duties to a person in the maintenance service industry.

3. For similar reasons, the lessor is entitled to protect its residual interest in the goods by prohibiting anyone but the lessee from possessing or using them. Accordingly, under subsection (3) (§ 4-2A-303(3)) if there is an actual transfer by the lessee of its right of possession or use of the goods in violation of a provision in the lease agreement, such a provision likewise is enforceable, giving rise to the rights and remedies stated in subsection (5) (§ 4-2A-303(5)). A transfer of the lessee's right of possession or use of the goods resulting from the enforcement of a security interest granted by the lessee in its leasehold interest is a "transfer by the lessee" under this subsection (§ 4-2A-303(3)).

4. Finally, subsection (3) (§ 4-2A-303(3)) protects against a claim that the creation or enforcement of a security interest in the lessor's interest under the lease contract or in the residual interest is a transfer that materially impairs the prospect of obtaining return performance by, materially changes the duty of, or materially increases the burden or risk imposed on the lessee so as to give rise to the rights and remedies stated in subsection (5) (§ 4-2A-303(5)), unless the transfer involves an actual delegation of a material performance of the lessor.

5. While it is not likely that a transfer by the lessor of its right to payment under the lease contract would impair at a future time the ability of the lessee to obtain the performance due the lessee under the lease contract from the lessor, if under the circumstances reasonable grounds for in-

security as to receiving that performance arise, the lessee may employ the provision of this Article (§ 4-2A-101 et seq.) for demanding adequate assurance of due performance and has the remedy provided in that circumstance. Section 2A-401 (§ 4-2A-401).

6. Sections 9-206 and 9-318(1) through (3) (§§ 4-9-206 and 4-9-318(1) — (3)) also are relevant. Section 9-206 (§ 4-9-206) sanctions an agreement by a lessee not to assert certain types of claims or defenses against the lessor's assignee. Section 9-318(1) through (3) (§ 4-9-318(1) — (3)) deal with, among other things, the other party's rights against the assignee where Section 9-206(1) (§ 4-9-206(1)) does not apply. Since the definition of contract under Section 1-201(11) (§ 4-1-201(11)) includes a lease agreement, the definition of account debtor under Section 9-105(1)(a) (§ 4-9-105(1)(a)) includes a lessee of goods. As a result, Section 9-206 (§ 4-9-206) applies to lease agreements, and there is no need to restate those sections in this Article (§ 4-2A-101 et seq.). The reference to "defenses or claims arising out of a sale" in Section 9-318(1) (§ 4-9-318(1)) should be interpreted broadly to include defenses or claims arising out of a lease inasmuch as that section (§ 4-9-318) codifies the common law rule with respect to contracts, including lease contracts.

7. Subsection (4) (§ 4-2A-303(4)) is based upon Section 2-210(2) and Section 9-318(4) (§§ 4-2-210(2) and 4-9-318(4)). It makes unenforceable a prohibition against transfers of certain rights to payment or a provision making the transfer an event of default. It also provides that such transfers do not materially impair the prospect of obtaining return performance by, materially change the duty of, or materially increase the burden or risk imposed on, the other party to the lease contract so as to give rise to the rights and remedies stated in subsection (5) (§ 4-2A-303(5)). Accordingly, a transfer of a right to payment cannot be prohibited or made an event of default, or be one that materially impairs performance, changes duties or increases risk, if the right is already due or will become due without further performance being required by the party to receive payment. Thus, a lessor can transfer the right to future payments under the lease contract, including by way of a grant of a security interest, and the



transfer will not give rise to the rights and remedies stated in subsection (5) (§ 4-2A-303(5)) if the lessor has no remaining performance under the lease contract. The mere fact that the lessor is obligated to allow the lessee to remain in possession and to use the goods as long as the lessee is not in default does not mean that there is "remaining performance" on the part of the lessor. Likewise, the fact that the lessor has potential liability under a "non-operating" lease contract for breaches of warranty does not mean that there is "remaining performance." In contrast, the lessor would have "remaining performance" under a lease contract requiring the lessor to regularly maintain and service the goods or to provide "upgrades" of the equipment on a periodic basis in order to avoid obsolescence. The basic distinction is between a mere potential duty to respond which is not "remaining performance," and an affirmative duty to render stipulated performance. Although the distinction may be difficult to draw in some cases, it is instructive to focus on the difference between "operating" and "non-operating" leases as generally understood in the marketplace. Even if there is "remaining performance" under a lease contract, a transfer for security of a right to payment that is made an event of default or that is in violation of a prohibition against transfer does not give rise to the rights and remedies under subsection (5) (§ 4-2A-303(5)) if it does not constitute an actual delegation of a material performance under subsection (3) (§ 4-2A-303(3)).

8. The application of either the rule of subsection (3) (§ 4-2A-303(3)) or the rule of subsection (4) (§ 4-2A-303(4)) to the grant by the lessor of a security interest in the lessor's right to future payment under the lease contract may produce the same result. Both subsections (§ 4-2A-303(3) and (4)) generally protect security transfers by the lessor in particular because the creation by the lessor of a security interest or the enforcement of that interest generally will not prejudice the lessee's rights if it does not result in a delegation of the lessor's duties. To the contrary, the receipt of loan proceeds or relief from the enforcement of an antecedent debt normally should enhance the lessor's ability to perform its duties under the lease contract. Nevertheless, there are circumstances

where relief might be justified. For example, if ownership of the goods is transferred pursuant to enforcement of a security interest to a party whose ownership would prevent the lessee from continuing to possess the goods, relief might be warranted. See 49 U.S.C. § 1401(a) and (b) which places limitations on the operation of aircraft in the United States based on the citizenship or corporate qualification of the registrant.

9. Relief on the ground of material prejudice when the lease agreement does not prohibit the transfer or make it an event of default should be afforded only in extreme circumstances, considering the fact that the party asserting material prejudice did not insist upon a provision in the lease agreement that would protect against such a transfer.

10. Subsection (5) (§ 4-2A-303(5)) implements the rule of subsection (2) (§ 4-2A-303(2)). Subsection (2) (§ 4-2A-303(2)) provides that, even though a transfer is effective, a provision in the lease agreement prohibiting it or making it an event of default may be enforceable as provided in subsection (5) (§ 4-2A-303(5)). See *Brummond v. First National Bank of Clovis*, 656 P.2d 884, 35 U.C.C. Rep. Serv. (Callaghan) 1311 (N. Mex. 1983), stating the analogous rule for Section 9-311 (§ 4-9-311). If the transfer prohibited by the lease agreement is made an event of default, then, under subsection 5(a) (§ 4-2A-303(5)(a)), unless the default is waived or there is an agreement otherwise, the aggrieved party has the rights and remedies referred to in Section 2A-501(2) (§ 4-2A-501(2)), viz. those in this Article (§ 4-2A-101 et seq.) and, except as limited in the Article (§ 4-2A-101 et seq.), those provided in the lease agreement. In the unlikely circumstance that the lease agreement prohibits the transfer without making a violation of the prohibition an event of default or, even if there is no prohibition against the transfer, and the transfer is one that materially impairs performance, changes duties, or increases risk (for example, a sublease or assignment to a party using the goods improperly or for an illegal purpose), then subsection 5(b) (§ 4-2A-303(5)(b)) is applicable. In that circumstance, unless the party aggrieved by the transfer has otherwise agreed in the lease contract, such as by assenting to a particular trans-

fer or to transfers in general, or agrees in some other manner, the aggrieved party has the right to recover damages from the transferor and a court may, in appropriate circumstances, grant other relief, such as cancellation of the lease contract or an injunction against the transfer.

11. If a transfer gives rise to the rights and remedies provided in subsection (5) (§ 4-2A-303(5)), the transferee as an alternative may propose, and the other party may accept, adequate cure or compensation for past defaults and adequate assurance of future due performance under the lease contract. Subsection (5) (§ 4-2A-303(5)) does not preclude any other relief that may be available to a party to the lease contract aggrieved by a transfer subject to an enforceable prohibition, such as an action for interference with contractual relations.

12. Subsection (8) (§ 4-2A-303(8)) requires that a provision in a consumer lease prohibiting a transfer, or making it an event of default, must be specific, written and conspicuous. See Section 1-201(10) (§ 4-1-201(10)). This assists in protecting a consumer lessee against surprise assertions of default.

13. Subsection (6) (§ 4-2A-303(6)) is taken almost verbatim from the provisions of Section 2-210(4) (§ 4-2-210(4)). The subsection (§ 4-2A-303(6)) states a rule of construction that distinguishes a commercial assignment, which substitutes the assignee for the assignor as to rights and duties, and an assignment for security or financing assignment, which substitutes the assignee for the assignor only as to rights. Note that the assignment for security or financing assignment is a subset of all security interests. Security interest is defined to include "any interest of a buyer of ... chattel paper". Section 1-201(37) (§ 4-1-201(37)). Chattel paper is defined to include a lease. Section 9-105(1)(b) (§ 4-9-105(1)(b)). Thus, a buyer of leases is the holder of a security

interest in the leases. That conclusion should not influence this issue, as the policy is quite different. Whether a buyer of leases is the holder of a commercial assignment, or an assignment for security or financing assignment should be determined by the language of the assignment or the circumstances of the assignment.

#### *Cross References:*

Sections 1-201(11), 1-201(37), 2-210, 2A-401, 9-102(1)(b), 9-104(f), 9-105(1)(a), 9-206, and 9-318 (§§ 4-1-201(11), 4-1-201(37), 4-2-210, 4-2A-401, 4-9-102(1)(b), 4-9-104(f), 4-9-105(1)(a), 4-9-206, and 4-9-318).

#### *Definitional Cross References:*

"Agreed" and "Agreement". Section 1-201(3) (§ 4-1-201(3)).

"Conspicuous". Section 1-201(10) (§ 4-1-201(10)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Lessor's residual interest". Section 2A-103(1)(q) (§ 4-2A-103(1)(q)).

"Notice". Section 1-201(25) (§ 4-1-201(25)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Term". Section 1-201(42) (§ 4-1-201(42)).

"Writing". Section 1-201(46) (§ 4-1-201(46)).

### **Official Comment to Section 2A-304 (A.C.A. § 4-2A-304)**

*Uniform Statutory Source:* Section 2-403 (§ 4-2-403).

*Changes:* While Section 2-403 (§ 4-2-403) was used as a model for this section, the provisions of Section 2-403 (§ 4-2-403) were significantly revised to reflect leas-

ing practices and to integrate this Article (§ 4-2A-101 et seq.) with certificate of title statutes.

#### *Purposes:*

1. This section (§ 4-2A-304) must be read in conjunction with, as it is subject



to, the provisions of Section 2A-303 (§ 4-2A-303), which govern voluntary and involuntary transfers of rights and duties under a lease contract, including the lessor's residual interest in the goods.

2. This section (§ 4-2A-304) must also be read in conjunction with Section 2-403 (§ 4-2-403). This section (§ 4-2A-304) and Section 2A-305 (§ 4-2A-305) are derived from Section 2-403 (§ 4-2-403), which states a unified policy on good faith purchase of goods. Given the scope of the definition of purchaser (Section 1-201(33)) (§ 4-1-201(33)), a person who bought goods to lease as well as a person who bought goods subject to an existing lease from a lessor will take pursuant to Section 2-403 (§ 4-2-403). Further, a person who leases such goods from the person who bought them should also be protected under Section 2-403 (§ 4-2-403), first because the lessee's rights are derivative and second because the definition of purchaser should be interpreted to include one who takes by lease; no negative implication should be drawn from the inclusion of lease in the definition of purchase in this Article (§ 4-2A-101 et seq.). Section 2A-103(1)(v) (§ 4-2A-103(1)(v)).

3. There are hypotheticals that relate to an entrustee's unauthorized lease of entrusted goods to a third party that are outside the provisions of Sections 2-403, 2A-304 and 2A-305 (§§ 4-2-403, 4-2A-304 and 4-2A-305). Consider a sale of goods by M, a merchant, to B, a buyer. After paying for the goods B allows M to retain possession of the goods as B is short of storage. Before B calls for the goods M leases the goods to L, a lessee. This transaction is not governed by Section 2-403(2) (§ 4-2-403(2)) as L is not a buyer in the ordinary course of business. Section 1-201(9) (§ 4-1-201(9)). Further, this transaction is not governed by Section 2A-304(2) (§ 4-2A-304(2)) as B is not an existing lessee. Finally, this transaction is not governed by Section 2A-305(2) (§ 4-2A-305(2)) as B is not M's lessor. Section 2A-307(2) (§ 4-2A-307(2)) resolves the potential dispute between B, M and L. By virtue of B's entrustment of the goods to M and M's lease of the goods to L, B has a cause of action against M under the common law. Sections 2A-103(4) and 1-103 (§§ 4-2A-103(4) and 4-1-103). See, e.g., Restatement (Second) of Torts §§ 222A-243. Thus, B is a creditor of M. Sections 2A-

103(4) and 1-201(12) (§§ 4-2A-103(4) and 4-1-201(12)). Section 2A-307(2) (§ 4-2A-307(2)) provides that B, as M's creditor, takes subject to M's lease to L. Thus, if L does not default under the lease, L's enjoyment and possession of the goods should be undisturbed. However, B is not without recourse. B's action should result in a judgment against M providing, among other things, a turnover of all proceeds arising from M's lease to L, as well as a transfer of all of M's right, title and interest as lessor under M's lease to L, including M's residual interest in the goods. Section 2A-103(1)(q) (§ 4-2A-103(1)(q)).

4. Subsection (1) (§ 4-2A-304(1)) states a rule with respect to the leasehold interest obtained by a subsequent lessee from a lessor of goods under an existing lease contract. The interest will include such leasehold interest as the lessor has in the goods as well as the leasehold interest that the lessor had the power to transfer. Thus, the subsequent lessee obtains unimpaired all rights acquired under the law of agency, apparent agency, ownership or other estoppel, whether based upon statutory provisions or upon case law principles. Sections 2A-103(4) and 1-103 (§§ 4-2A-103(4) and 4-1-103). In general, the subsequent lessee takes subject to the existing lease contract, including the existing lessee's rights thereunder. Furthermore, the subsequent lease contract is, of course, limited by its own terms, and the subsequent lessee takes only to the extent of the leasehold interest transferred thereunder.

5. Subsection (1) (§ 4-2A-304(1)) further provides that a lessor with voidable title has power to transfer a good leasehold interest to a good faith subsequent lessee for value. In addition, subsections (1)(a) through (d) (§ 4-2A-304(1)(a) — (d)) provide specifically for the protection of the good faith subsequent lessee for value in a number of specific situations which have been troublesome under prior law.

6. The position of an existing lessee who entrusts leased goods to its lessor is not distinguishable from the position of other entrusters. Thus, subsection (2) (§ 4-2A-304(2)) provides that the subsequent lessee in the ordinary course of business takes free of the existing lease contract between the lessor entruster and the lessee entruster, if the lessor is a

merchant dealing in goods of that kind. Further, the subsequent lessee obtains all of the lessor entrustee's and the lessee entruster's rights to the goods, but only to the extent of the leasehold interest transferred by the lessor entrustee. Thus, the lessor entrustee retains the residual interest in the goods. Section 2A-103(1)(q) (§ 4-2A-103 (1) (q)). However, entrustment by the existing lessee must have occurred before the interest of the subsequent lessee became enforceable against the lessor. Entrusting is defined in Section 2-403(3) (§ 4-2-403(3)) and that definition applies here. Section 2A-103(3) (§ 4-2A-103(3)).

7. Subsection (3) (§ 4-2A-304(3)) states a rule with respect to a transfer of goods from a lessor to a subsequent lessee where the goods are subject to an existing lease and covered by a certificate of title. The subsequent lessee's rights are no greater than those provided by this section (§ 4-2A-304) and the applicable certificate of title statute, including any applicable case law construing such statute. Where the relationship between the certificate of title statute and Section 2-403 (§ 4-2-403), the statutory analogue to this section, has been construed by a court, that construction is incorporated here. Sections 2A-103(4) and 1-102(1) and (2) (§§ 4-2A-103(4) and 4-1-102(1) and (2)). The better rule is that the certificate of title statutes are in harmony with Section 2-403 (§ 4-2-403) and thus would be in harmony with this section (§ 4-2A-304). E.g., *Atwood Chevrolet-Olds v. Aberdeen Mun. School Dist.*, 431 So.2d 926, 928 (Miss. 1983); *Godfrey v. Gilsdorf*, 476 P.2d 3, 6, 86 Nev. 714, 718 (1970); *Martin v. Nager*, 192 N.J. Super. 189, 197-98, 469 A.2d 519, 523 (Super. Ct. Ch. Div. 1983). where the certificate of title statute is silent on this

issue of transfer, this section (§ 4-2A-304) will control.

#### *Cross References:*

Sections 1-102, 1-103, 1-201(33), 2-403, 2A-103(1)(v), 2A-103(3), 2A-103(4), 2A-303 and 2A-305 (§§ 4-1-102, 4-1-103, 4-1-201(33), 4-2-403, 4-2A-103(1)(v), 4-2A-103(3), 4-2A-103(4), 4-2A-303 and 4-2A-305).

#### *Definitional Cross References:*

"Agreed". Section 1-201(3) (§ 4-1-201(3)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Entrusting". Section 2-403 (3) (§ 4-2-403(3)).

"Good faith". Sections 1-201(19) and 2-103(1)(b) (§§ 4-1-201(19) and 4-2-103(1)(b)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Leasehold interest". Section 2A-103(1)(m) (§ 4-2A-103(1)(m)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessee in the ordinary course of business". Section 2A-103(1)(o) (§ 4-2A-103(1)(o)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Merchant". Section 2-104(1) (§ 4-2-104(1)).

"Purchase". Section 2A-103(1)(v) (§ 4-2A-103(1)(v)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

### **Official Comment to Section 2A-305 (A.C.A. § 4-2A-305)**

*Uniform Statutory Source:* Section 2-403 (§ 4-2-403).

*Changes:* While Section 2-403 (§ 4-2-403) was used as a model for this section (§ 4-2A-305), the provisions of Section 2-403 (§ 4-2-403) were significantly revised to reflect leasing practice and to integrate this Article (§ 4-2A-101 et seq.) with certificate of title statutes.

#### *Purposes:*

This section (§ 4-2A-305), a companion

to Section 2A-304 (§ 4-2A-304), cites the rule with respect to the leasehold interest obtained by a buyer or sublessee from a lessee of goods under an existing lease contract. Cf. Section 2A-304 (§ 4-2A-304) official comment. Note that this provision (§ 4-2A-305) is consistent with existing case law, which prohibits the bailee's transfer of title to a good faith purchaser for value under Section 2-403(1) (§ 4-2-403(1)). *Rohweder v. Aberdeen Product. Credit Ass'n*, 765 F.2d 109 (8th Cir. 1985).



Subsection (2) (§ 4-2A-305(2)) is also consistent with existing case law. *American Standard Credit, Inc. v. National Cement Co.*, 643 F.2d 248, 269-70 (5th Cir. 1981); but cf. *Exxon Co. U.S.A. v. TLW Commuter Indus.*, 37 U.C.C. Rep. Serv. (Callaghan) 1052, 1057-58 (D. Mass. 1983). Unlike Section 2A-304(2) (§ 4-2A-304(2)), this subsection (§ 4-2A-305(2)) does not contain any requirement with respect to the time that the goods were entrusted to the merchant. In Section 2A-304(2) (§ 4-2A-304(2)) the competition is between two customers of the merchant lessor; the time of entrusting was added as a criterion to create additional protection to the customer who was first in time: the existing lessee. In subsection (2) (§ 4-2A-305(2)) the equities between the competing interests were viewed as balanced.

There appears to be some overlap between Section 2-403(2) (§ 4-2-403(2)) and Section 2A-305(2) (§ 4-2A-305(2)) with respect to a buyer in the ordinary course of business. However, an examination of this Article's (§ 4-2A-101 et seq.) definition of buyer in the ordinary course of business (Section 2A-103(1)(a)) (§ 4-2A-103(1)(a)) makes clear that this reference was necessary to treat entrusting in the context of a lease.

Subsection (3) (§ 4-2A-305(3)) states a rule of construction with respect to a transfer of goods from a lessee to a buyer or sublessee, where the goods are subject to an existing lease and covered by a certificate of title. Cf. Section 2A-304 (§ 4-2A-304) official comment.

#### *Cross References:*

Sections 2-403, 2A-103(1)(a), 2A-304

and 2A-305(2) (§§ 4-2-403, 4-2A-103(1)(a), 4-2A-304 and 4-2A-305(2)).

#### *Definitional Cross References:*

"Buyer". Section 2-103(1)(a) (§ 4-2-103(1)(a)).

"Buyer in the ordinary course of business". Section 2A-103(1)(a) (§ 4-2A-103(1)(a)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Entrusting". Section 2-403(3) (§ 4-2-403(3)).

"Good faith". Sections 1-201(19) and 2-103(1)(b) (§§ 4-1-201(19) and 4-2-103(1)(b)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Leasehold interest". Section 2A-103(1)(m) (§ 4-2A-103(1)(m)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessee in the ordinary course of business". Section 2A-103(1)(o) (§ 4-2A-103(1)(o)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Merchant". Section 2-104(1) (§ 4-2-104(1)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Sale". Section 2-106(1) (§ 4-2-106(1)).

"Sublease". Section 2A-103(1)(w) (§ 4-2A-103(1)(w)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

### **Official Comment to Section 2A-306 (A.C.A. § 4-2A-306)**

*Uniform Statutory Source:* Section 9-310 (§ 4-9-310).

*Changes:* The approach reflected in the provisions of Section 9-310 (§ 4-9-310) was included, but revised to conform to leasing terminology and to expand the exception to the special priority granted to protected liens to cover liens created by rule of law as well as those created by statute.

*Purposes:* This section (§ 4-2A-306) should be interpreted to allow a qualified lessor or a qualified lessee to be the com-

peting lienholder if the statute or rule of law so provides. The reference to statute includes applicable regulations and cases; these sources must be reviewed in resolving a priority dispute under this section (§ 4-2A-306).

#### *Cross References:*

Section 9-310 (§ 4-9-310).

#### *Definitional Cross References:*

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease Contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Lien". Section 2A-103(1)(r) (§ 4-2A-103(1)(r)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

### Official Comment to Section 2A-307 (A.C.A. § 4-2A-307)

*Uniform Statutory Source:* None for subsection (1) (§ 4-2A-307(1)). Subsection (2) (§ 4-2A-307(2)) is derived from Section 9-301 (§ 4-9-301), and subsections (3) and (4) (§ 4-2A-307(3) and (4)) are derived from Section 9-307(1) and (3) (§ 4-9-307(1) and (3)), respectively.

*Changes:* The provisions of Sections 9-301 and 9-307(1) and (3) (§§ 4-9-301 and 4-9-307(1) and (3)) were incorporated, and modified to reflect leasing terminology and the basic concepts reflected in this Article (§ 4-2A-101 et seq.).

#### *Purposes:*

1. Subsection (1) (§ 4-2A-307(1)) states a general rule of priority that a creditor of the lessee takes subject to the lease contract. The term lessee (Section 2A-103(1)(n)) (§ 4-2A-103(1)(n)) includes sublessee. Therefore, this subsection (§ 4-2A-307(1)) not only covers disputes between the prime lessor and a creditor of the prime lessee but also disputes between the prime lessor, or the sublessor, and a creditor of the sublessee. Section 2A-301 (§ 4-2A-301) official comment 3(g). Further, by using the term creditor (Section 1-201(12)) (§ 4-1-201(12)), this subsection (§ 4-2A-307(1)) will cover disputes with a general creditor, a secured creditor, a lien creditor and any representative of creditors. Section 2A-103(4) (§ 4-2A-103(4)).

2. Subsection (2) (§ 4-2A-307(2)) states a general rule of priority that a creditor of a lessor takes subject to the lease contract. Note the discussion above with regard to the scope of these rules. Section 2A-301 (§ 4-2A-301) official comment 3(g). Thus, the section (§ 4-2A-307) will not only cover disputes between the prime lessee and a creditor of the prime lessor but also disputes between the prime lessee, or the sublessee, and a creditor of the sublessor.

3. To take priority over the lease contract, and the interests derived therefrom, the creditor must come within one of three exceptions stated within the rule. First, subsection (2) (a) (§ 4-2A-307(2)(a)) pro-

vides that where the creditor holds a lien (Section 2A-103(1)(r)) (§ 4-2A-103(1)(r)) that attached before the lease contract became enforceable (Section 2A-301) (§ 4-2A-301), the creditor does not take subject to the lease. Second, subsection (2)(b) (§ 4-2A-307(2)(b)) provides that when the creditor holds a security interest (Section 1-201(37)) (§ 4-1-201(37)), whether or not perfected, the creditor has priority over a lessee who did not give value (Section 1-201(44)) (§ 4-1-201(44)) and receive delivery of the goods without knowledge (Section 1-201(25)) (§ 4-1-201(25)) of the security interest. As to other lessees, under subsection (2)(c) (§ 4-2A-307(2)(c)) a secured creditor holding a perfected security interest before the time the lease contract became enforceable (Section 2A-301) (§ 4-2A-301) does not take subject to the lease. With respect to this provision (§ 4-2A-307(2)(c)), the lessee in these circumstances is treated like a buyer so that perfection of a purchase money security interest does not relate back (Section 9-301) (§ 4-9-301).

4. The rules of this section (§ 4-2A-307) operate in favor of whichever party to the lease contract may enforce it, even if one party perhaps may not, e.g., under Section 2A-201(1)(b) (§ 4-2A-201(1)(b)).

5. The rules stated in subsections (2) (b) and (c) (§ 4-2A-307(2) (b) and (c)), and the rule in subsection (3) (§ 4-2A-307 (3)), are best understood by reviewing a hypothetical. Assume that a merchant engaged in the business of selling and leasing musical instruments obtained possession of a truck load of musical instruments on deferred payment terms from a supplier of musical instruments on January 6. To secure payment of such credit the merchant granted the supplier a security interest in the instruments; the security interest was perfected by filing on January 15. The merchant, as lessor, entered into a lease to an individual of one of the musical instruments supplied by the supplier; the lease became enforceable on January 10. Under subsection (2)(b) (§ 4-



2A-307(2)(b)) the lessee will prevail (assuming the lessee qualifies thereunder) unless subsection (c) (§ 4-2A-307(2)(c)) provides otherwise. Under the rule stated in subsection (2) (c) (§ 4-2A-307 (2) (c)) a priority dispute between the supplier, as the lessor's secured creditor, and the lessee would be determined by ascertaining on January 10 (the day the lease became enforceable) the validity and perfected status of the security interest in the musical instrument and the enforceability of the lease contract by the lessee. Nothing more appearing, under the rule stated in subsection (2) (c) (§ 4-2A-307(2) (c)), the supplier's security interest in the musical instrument would not have priority over the lease contract. Moreover, subsection (2) (§ 4-2A-307(2)) states that its rules are subject to the rules of subsections (3) and (4) (§ 4-2A-307(3) and (4)). Under this hypothetical the lessee should qualify as a "lessee in the ordinary course of business". Section 2A-103(1)(o) (§ 4-2A-103(1)(o)). Subsection (3) (§ 4-2A-307(3)) also makes clear that the lessee in the ordinary course of business will win even if he or she knows of the existence of the supplier's security interest.

6. Subsections (3) and (4) (§ 4-2A-307(3) and 4)), which are modeled on the provisions of Section 9-307(1) and (3) (§ 4-9-307(1) and (3)) respectively, state two exceptions to the priority rule stated in subsection (2) (§ 4-2A-307(2)) with respect to a creditor who holds a security interest. The lessee in the ordinary course of business will be treated in the same fashion as the buyer in the ordinary course of business, given a priority dispute with a secured creditor over goods subject to a lease contract.

### Official Comment to Section 2A-308 (A.C.A. § 4-2A-308)

*Uniform Statutory Source:* Section 2-402(2) and (3)(b) (§ 4-2-402(2) and (3)(b)).

*Changes:* Rephrased and new material added to conform to leasing terminology and practice.

*Purposes:*

Subsection (1) (§ 4-2A-308(1)) states a general rule of avoidance where the lessor has retained possession of goods if such retention is fraudulent under any statute or rule of law. However, the subsection

### *Cross References:*

Sections 1-201(12), 1-201(25), 1-201(37), 1-201(44), 2A-103(1)(n), 2A-103(1)(o), 2A-103(1)(r), 2A-103(4), 2A-201(1)(b), 2A-301 official comment 3(g), Article 9, especially Sections 9-301, 9-307(1) and 9-303(3) (§§ 4-1-201(12), 4-1-201(25), 4-1-201(37), 4-1-201(44), 4-2A-103(1)(n), 4-2A-103(1)(o), 4-2A-103(1)(r), 4-2A-103(4), 4-2A-201(1)(b), 4-2A-301 official cogent 3(g), 4-9-101 et seq., especially §§ 4-9-301, 4-9-307(1) and 4-9-303(3)).

### *Definitional Cross References:*

"Creditor". Section 1-201(12) (§ 4-1-201(12)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Knowledge" and "Knows". Section 1-201(25) (§ 4-1-201(25)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Leasehold interest". Section 2A-103(1)(m) (§ 4-2A-103(1)(m)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessee in the ordinary course of business". Section 2A-103(1)(o) (§ 4-2A-103(1)(o)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Lien". Section 2A-103(1)(r) (§ 4-2A-103(1)(r)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Pursuant to commitment". Section 2A-103(3) (§ 4-2A-103(3)).

"Security interest". Section 1-201(37) (§ 4-1-201(37)).

(§ 4-2A-308(1)) creates an exception under certain circumstances for retention of possession of goods for a commercially reasonable time after the lease contract becomes enforceable.

Subsection (2) (§ 4-2A-308(2)) also preserves the possibility of an attack on the lease by creditors of the lessor if the lease was made in satisfaction of or as security for a pre-existing claim, and would constitute a fraudulent transfer or voidable preference under other law.

Finally, subsection (3) (§ 4-2A-308(3))

states a new rule with respect to sale-leaseback transactions, i.e., transactions where the seller sells goods to a buyer but possession of the goods is retained by the seller pursuant to a lease contract between the buyer as lessor and the seller as lessee. Notwithstanding any statute or rule of law that would treat such retention as fraud, whether per se, prima facie, or otherwise, the retention is not fraudulent if the buyer bought for value (Section 1-201(44)) (§ 4-1-201(44)) and in good faith (Sections 1-201(19) and 2-103(1)(b)) (§§ 4-1-201(19) and 4-2-103(1)(b)). Section 2A-103(3) and (4) (§ 4-2A-103(3) and (4)). This provision (§ 4-2A-308(3)) overrides Section 2-402(2) (§ 4-2-402(2)) to the extent it would otherwise apply to a sale-leaseback transaction.

*Cross References:*

Sections 1-201(19), 1-201(44), 2-402(2) and 2A-103(4) (§§ 4-1-201(19), 4-1-201(44), 4-2-402(2) and 4-2A-103(4)).

*Definitional Cross References:*

"Buyer". Section 2-103(1)(a) (§ 4-2-103(1)(a)).

"Contract". Section 1-201(11) (§ 4-1-201(11)).

"Creditor". Section 1-201(12) (§ 4-1-201(12)).

"Good faith". Sections 1-201(19) and 2-103(1)(b) (§§ 4-1-201(19) and 4-2-103(1)(b)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Money". Section 1-201(24) (§ 4-1-201(24)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Sale". Section 2-106(1) (§ 4-2-106(1)).

"Seller". Section 2-103(1)(d) (§ 4-2-103(1)(d)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

**Official Comment to Section 2A-309 (A.C.A. § 4-2A-309)\***

*Uniform Statutory Source:* Section 9-313 (§ 4-9-313).

*Changes:* Revised to reflect leasing terminology and to add new material.

*Purposes:*

1. While Section 9-313 (§ 4-9-313) provided a model for this section (§ 4-2A-309), certain provisions were substantially revised.

2. Section 2A-309(1)(c) (§ 4-2A-309(1)(c)), which is new, defines purchase money lease to exclude leases where the lessee had possession or use of the goods or the right thereof before the lease agreement became enforceable. This term is used in subsection (4)(a) (§ 4-2A-309(4)(a)) as one of the conditions that must be satisfied to obtain priority over the conflicting interest of an encumbrancer or owner of the real estate.

3. Section 2A-309(4) (§ 4-2A-309(4)), which states one of several priority rules found in this section (§ 4-2A-309), deletes reference to office machines and the like (Section 9-313(4)(c)) (§ 4-9-313(4)(c)) as well as certain liens (Section 9-313(4)(d))

(§ 4-9-313(4)(d)). However, these items are included in subsection (5) (§ 4-2A-309(5)), another priority rule that is more permissive than the rule found in subsection (4) (§ 4-2A-309(4)) as it applies whether or not the interest of the lessor is perfected. In addition, subsection (5)(a) (§ 4-2A-309(5)(a)) expands the scope of the provisions of Section 9-313(4)(c) (§ 4-9-313(4)(c)) to include readily removable equipment not primarily used or leased for use in the operation of real estate; the qualifier is intended to exclude from the expanded rule equipment integral to the operation of real estate, e.g., heating and air conditioning equipment.

4. The rule stated in subsection (7) (§ 4-2A-309(7)) is more liberal than the rule stated in Section 9-313(7) (§ 4-9-313(7)) in that issues of priority not otherwise resolved in this subsection (§ 4-2A-309(7)) are left for resolution by the priority rules governing conflicting interests in real estate, as opposed to the Section 9-313(7) (§ 4-9-313(7)) automatic subordination of the security interest in fixtures. Note that, for the purpose of this



section (§ 4-2A-309), where the interest of an encumbrancer or owner of the real estate is paramount to the interest of the lessor, the latter term includes the residual interest of the lessor.

5. The rule stated in subsection (8) (§ 4-2A-309(8)) is more liberal than the rule stated in Section 9-313(8) (§ 4-9-313(8)) in that the right of removal is extended to both the lessor and the lessee and the occasion for removal includes expiration, termination or cancellation of the lease agreement, and enforcement of rights and remedies under this Article (§ 4-2A-101 et seq.), as well as default. The new language also provides that upon removal the goods are free and clear of conflicting interests of owners and encumbrancers of the real estate.

6. Finally, subsection (9) (§ 4-2A-309(9)) provides a mechanism for the lessor of fixtures to perfect its interest by filing a financing statement under the provisions of the Article on Secured Transactions (Article 9) (§ 4-9-101 et seq.), even though the lease agreement does not create a security interest. Section 1-201(37) (§ 4-1-201(37)). The relevant provisions of Article 9 (§ 4-9-101 et seq.) must be interpreted permissively to give effect to this mechanism as it implicitly expands the scope of Article 9 (§ 4-9-101 et seq.) so that its filing provisions apply to transactions that create a lease of fixtures, even though the lease agreement does not create a security interest. This mechanism is similar to that provided in Section 2-326(3)(c) (§ 4-2-326(3)(c)) for the seller of goods on consignment, even though the consignment is not "intended as security". Section 1-201(37) (§ 4-1-201(37)). Given the lack of litigation with respect to the mechanism created for consignment sales, this new mechanism should prove effective.

#### *Cross References:*

Sections 1-201(37), 2A-309(1)(c), 2A-309(4), Article 9, especially Sections 9-313, 9-313(4)(c), 9-313(4)(d), 9-313(7), 9-313(8) and 9-408 (§§ 4-1-201(37), 4-2A-309(1)(c), 4-2A-309(4), 4-9-101 et seq., es-

pecially §§ 4-9-313, 4-9-313(4)(c), 4-9-313(4)(d), 4-9-313(7), 4-9-313(8) and 4-9-498).

#### *Definitional Cross References:*

"Agreed". Section 1-201(3) (§ 4-1-201(3)).

"Cancellation". Section 2A-103(1)(b) (§ 4-2A-103(1)(b)).

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Consumer lease". Section 2A-103(1)(e) (§ 4-2A-103(1)(e)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Lien". Section 2A-103(1)(r) (§ 4-2A-103(1)(r)).

"Mortgage". Section 9-105(1)(j) (§ 4-9-105(1)(j)).

"Party". Section 1-201(2.9) (§ 4-1-201(29)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Security interest". Section 1-201(37) (§ 4-1-201(37)).

"Termination". Section 2A-103(1)(z) (§ 4-2A-103(1)(z)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

"Writing". Section 1-201(46) (§ 4-1-201(46)).

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\*Arkansas added language to § 4-2A-309(9).

### **Official Comment to Section 2A-310 (A.C.A. § 4-2A-310)**

*Uniform Statutory Source:* Section 9-314 (§ 4-9-314).

*Changes:* Revised to reflect leasing terminology and to add new material.

*Purposes:*

Subsections (1) and (2) (§ 4-2A-310(1) and (2)) restate the provisions of subsection (1) of Section 9-314 (§ 4-9-314(1)) to clarify the definition of accession and to add leasing terminology to the priority rule that applies when the lease is entered into before the goods become accessions. Subsection (3) (§ 4-2A-310(3)) restates the provisions of subsection (2) of Section 9-314 (§ 4-9-314(2)) to add leasing terminology to the priority rule that applies when the lease is entered into on or after the goods become accessions. Unlike the rule with respect to security interests, the lease is merely subordinate, not invalid.

Subsection (4) (§ 4-2A-310(4)) creates two exceptions to the priority rules stated in subsections (2) and (3) (§ 4-2A-310(2) and (3)). Subsection (4) (§ 4-2A-310(4)) deletes the special priority rule found in the provisions of Section 9-314(3)(b) (§ 4-9-314(3)(b)) as the interests of the lessor and lessee are entitled to greater protection.

Finally, subsection (5) (§ 4-2A-310(5)) is modeled on the provisions of Section 9-314(4) (§ 4-9-314(4)) with respect to removal of accessions, restated to reflect the parallel changes in Section 2A-309(8) (§ 4-2A-309(8)).

Neither this section (§ 4-2A-310) nor Section 9-314 (§ 4-9-314) governs where the accession to the goods is not subject to the interest of a lessor or a lessee under a lease contract and is not subject to the interest of a secured party under a security agreement. This issue is to be resolved by the courts, case by case.

*Cross References:*

Sections 2A-309(8), 9-314(1), 9-314(2), 9-314(3)(b), 9-314(4) (§§ 4-2A-309(8), 4-9-314(1), 4-9-314(2), 4-9-314(3)(b), 4-9-314(4)).

*Definitional Cross References:*

"Agreed". Section 1-201(3) (§ 4-1-201(3)).

"Buyer in the ordinary course of business". Section 2A-103(1)(a) (§ 4-2A-103(1)(a)).

"Cancellation". Section 2A-103(1)(b) (§ 4-2A-103(1)(b)).

"Creditor". Section 1-201(12) (§ 4-1-201(12)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Holder". Section 1-201(20) (§ 4-1-201(20)).

"Knowledge". Section 1-201(25) (§ 4-1-201(25)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessee in the ordinary course of business". Section 2A-103(1)(o) (§ 4-2A-103(1)(o)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Security interest". Section 1-201(37) (§ 4-1-201(37)).

"Termination". Section 2A-103(1)(z) (§ 4-2A-103(1)(z)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

"Writing". Section 1-201(46) (§ 4-1-201(46)).

**Official Comment to Section 2A-311 (A.C.A. § 4-2A-311)**

*Uniform Statutory Source:* Section 9-316 (§ 4-9-316).

*Purposes:* The several preceding sections deal with questions of priority. This section (§ 4-2A-311) is inserted to make it entirely clear that a person entitled to priority may effectively agree to subordinate the claim. Only the person entitled to

priority may make such an agreement; the rights of such a person cannot be adversely affected by an agreement to which that person is not a party.

*Cross References:*

Sections 1-102 and 2A-304 through 2A-310 (§§ 4-1-102 and 4-2A-304 — 4-2A-310).



*Definitional Cross References:*

"Agreement". Section 1-201(3) (§ 4-1-201(3)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

**Official Comment to Section 2A-401 (A.C.A. § 4-2A-401)**

*Uniform Statutory Source:* Section 2-609 (§ 4-2-609).

*Changes:* Revised to reflect leasing practices and terminology. Note that in the analogue to subsection (3) (§ 4-2A-401(3)) (Section 2-609(4)) (§ 4-2-609(4)), the adjective "justified" modifies demand. The adjective was deleted here as unnecessary, implying no substantive change.

*Definitional Cross References:*

"Aggrieved party". Section 1-201(2) (§ 4-1-201(2)).

"Agreed". Section 1-201(3) (§ 4-1-201(3)).

"Between merchants". Section 2-104(3) (§ 4-2-104(3)).

"Conforming". Section 2A-103(1) (d) (§ 4-2A-103(1) (d)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Receipt". Section 2-103(1)(c) (§ 4-2-103(1)(c)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Writing". Section 1-201(46) (§ 4-1-201(46)).

**Official Comment to Section 2A-402 (A.C.A. § 4-2A-402)**

*Uniform Statutory Source:* Section 2-610 (§ 4-2-610).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

"Aggrieved party". Section 1-201(2) (§ 4-1-201(2)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notifies". Section 1-201(26) (§ 4-1-201(26)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

**Official Comment to Section 2A-403 (A.C.A. § 4-2A-403)**

*Uniform Statutory Source:* Section 2-611 (§ 4-2-611).

*Changes:* Revised to reflect leasing practices and terminology. Note that in the analogue to subsection (2) (§ 4-2A-403(2)) (Section 2-611(2)) (§ 4-2-611(2)) the adjective "justifiably" modifies demanded. The adjective was deleted here (as it was in Section 2A-401) (§ 4-2A-401) as unnecessary, implying no substantive change.

*Definitional Cross References:*

"Aggrieved party". Section 1-201(2) (§ 4-1-201(2)).

"Cancellation". Section 2A-103(1)(b) (§ 4-2A-103(1)(b)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

**Official Comment to Section 2A-404 (A.C.A. § 4-2A-404)**

*Uniform Statutory Source:* Section 2-614 (§ 4-2-614).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

“Agreed”. Section 1-201(3) (§ 4-1-201(3)).

“Delivery”. Section 1-201(14) (§ 4-1-201(14)).

“Fault”. Section 2A-103(1)(f) (§ 4-2A-103(1)(f)).

“Lessee”. Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

“Lessor”. Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

“Supplier”. Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

**Official Comment to Section 2A-405 (A.C.A. § 4-2A-405)**

*Uniform Statutory Source:* Section 2-615 (§ 4-2-615).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

“Agreed”. Section 1-201(3) (§ 4-1-201(3)).

“Contract”. Section 1-201(11) (§ 4-1-201(11)).

“Delivery”. Section 1-201(14) (§ 4-1-201(14)).

“Finance lease”. Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

“Good faith”. Sections 1-201(19) and 2-103(1)(b) (§§ 4-1-01(19) and 4-2-103(1)(b)).

“Knows”. Section 1-201(25) (§ 4-1-201(25)).

“Lease”. Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

“Lease contract”. Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

“Lessee”. Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

“Lessor”. Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

“Notifies”. Section 1-201(26) (§ 4-1-201(26)).

“Sale”. Section 2-106(1) (§ 4-2-106(1)).

“Seasonably”. Section 1-204(3) (§ 4-1-204(3)).

“Supplier”. Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

**Official Comment to Section 2A-406 (A.C.A. § 4-2A-406)**

*Uniform Statutory Source:* Section 2-616(1) and (2) (§ 4-2-616(1) and (2)).

*Changes:* Revised to reflect leasing practices and terminology. Note that subsection 1(a) (§ 4-2A-406(1)(a)) allows the lessee under a lease, including a finance lease, the right to terminate the lease for excused performance (Sections 2A-404 and 2A-405) (§§ 4-2A-404 and 4-2A-405). However, subsection 1(b) (§ 4-2A-406(1)(b)), which allows the lessee the right to modify the lease for excused performance, excludes a finance lease that is not a consumer lease. This exclusion is compelled by the same policy that led to codification of provisions with respect to irrevocable promises. Section 2A-407 (§ 4-2A-407).

*Definitional Cross References:*

“Consumer lease”. Section 2A-103(1)(e) (§ 4-2A-103(1)(e)).

“Delivery”. Section 1-201(14) (§ 4-1-201(14)).

“Finance lease”. Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

“Goods”. Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

“Installment lease contract”. Section 2A-103(1)(i) (§ 4-2A-103(1)(i)).

“Lease agreement”. Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

“Lease contract”. Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

“Lessee”. Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

“Lessor”. Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

“Notice”. Section 1-201(25) (§ 4-1-201(25)).

“Reasonable time”. Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

“Receipt”. Section 2-103(1)(c) (§ 4-2-103(1)(c)).



"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Termination". Section 2A-103(1)(z) (§ 4-2A-103(1)(z)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

"Written". Section 1-201(46) (§ 4-1-201(46)).

### Official Comment to Section 2A-407 (A.C.A. § 4-2A-407)

*Uniform Statutory Source:* None.

#### *Purposes:*

1. This section (§ 4-2A-407) extends the benefits of the classic "hell or high water" clause to a finance lease that is not a consumer lease. This section (§ 4-2A-407) is self-executing; no special provision need be added to the contract. This section (§ 4-2A-407) makes covenants in a finance lease irrevocable and independent due to the function of the finance lessor in a three party relationship: the lessee is looking to the supplier to perform the essential covenants and warranties. Section 2A-209 (§ 4-2A-209). Thus, upon the lessee's acceptance of the goods the lessee's promises to the lessor under the lease contract become irrevocable and independent. The provisions of this section (§ 4-2A-407) remain subject to the obligation of good faith (Sections 2A-103(4) and 1-203) (§§ 4-2A-103(4) and 4-1-203), and the lessee's revocation of acceptance (Section 2A-517) (§ 4-2A-517).

2. The section (§ 4-2A-407) requires the lessee to perform even if the lessor's performance after the lessee's acceptance is not in accordance with the lease contract; the lessee may, however, have and pursue a cause of action against the lessor, e.g., breach of certain limited warranties (Sections 2A-210 and 2A-211(1)) (§§ 4-2A-210 and 4-2A-211(1)). This is appropriate because the benefit of the supplier's promises and warranties to the lessor under the supply contract and, in some cases, the warranty of a manufacturer who is not the supplier, is extended to the lessee under the finance lease. Section 2A-209 (§ 4-2A-209). Despite this balance, this section (§ 4-2A-407) excludes a finance lease that is a consumer lease. That a consumer be obligated to pay notwithstanding defective goods or the like is a principle that is not tenable under case law (*Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967)), state statute (Unif. Consumer Credit Code §§ 3.403-405, 7A U.L.A. 126-31 (1974), or federal statute (15 U.S.C. § 1666i (1982))).

3. The relationship of the three parties to a transaction that qualifies as a finance lease is best demonstrated by a hypothetical. A, the potential lessor, has been contracted by B, the potential lessee, to discuss the lease of an expensive line of equipment that B has recently placed an order for with C, the manufacturer of such goods. The negotiation is completed and A, as lessor, and B, as lessee, sign a lease of the line of equipment for a 60-month term. B, as buyer, assigns the purchase order with C to A. If this transaction creates a lease (Section 2A-103(1)(j)) (§ 4-2A-103(1)(j)), this transaction should qualify as a finance lease. Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

4. The line of equipment is delivered by C to B's place of business. After installation by C and testing by B, B accepts the goods by signing a certificate of delivery and acceptance, a copy of which is sent by B to A and C. One year later the line of equipment malfunctions and B falls behind in its manufacturing schedule.

5. Under this Article (§ 4-2A-101 et seq.), because the lease is a finance lease, no warranty of fitness or merchantability is extended by A to B. Sections 2A-212(1) and 2A-213 (§§ 4-2A-212(1) and 4-2A-213). Absent an express provision in the lease agreement, application of Section 2A-210 (§ 4-2A-210) or Section 2A-211(1) (§ 4-2A-211(1)), or application of the principles of law and equity, including the law with respect to fraud, duress, or the like (Sections 2A-103 (4) and 1-103) (§§ 4-2A-103 (4) and 4-1-103), B has no claim against A. B's obligation to pay rent to A continues as the obligation became irrevocable and independent when B accepted the line of equipment (Section 2A-407(1)) (§ 4-2A-407(1)). B has no right of set-off with respect to any part of the rent still due under the lease. Section 2A-508(6) (§ 4-2A-508(6)). However, B may have another remedy. Despite the lack of privity between B and C (the purchase order with C having been assigned by B to A), B may have a claim against C. Section 2A-209(1) (§ 4-2A-209(1)).

6. This section (§ 4-2A-407) does not address whether a "hell or high water" clause, i.e., a clause that is to the effect of this section (§ 4-2A-407), is enforceable if included in a finance lease that is a consumer lease or a lease that is not a finance lease. That issue will continue to be determined by the facts of each case and other law which this section (§ 4-2A-407) does not affect. Sections 2A-104, 2A-103(4), 9-206 and 9-318 (§§ 4-2A-104, 4-2A-103(4), 4-9-206 and 4-9-318). However, with respect to finance leases that are not consumer leases courts have enforced "hell or high water" clauses. *In re O.P.M. Leasing Servs.*, 21 Bankr. 993, 1006 (Bankr. S.D.N.Y. 1982).

7. Subsection (2) (§ 4-2A-407(2)) further provides that a promise that has become irrevocable and independent under subsection (1) (§ 4-2A-407(1)) is enforceable not only between the parties but also against third parties. Thus, the finance lease can be transferred or assigned without disturbing enforceability. Further, subsection (2) (§ 4-2A-407(2)) also provides that the promise cannot, among other things, be cancelled or terminated without the consent of the lessor.

#### Cross References:

Sections 1-103, 1-203, 2A-103(1)(g), 2A-103(1)(j), 2A-103(4), 2A-104, 2A-209, 2A-209(1), 2A-210, 2A-211(1), 2A-212(1), 2A-213, 2A-517(1)(b), 9-206 and 9-318 (§§ 4-1-103, 4-1-203, 4-2A-103(1)(g), 4-2A-103(1)(j), 4-2A-103(4), 4-2A-104, 4-2A-209, 4-2A-209(1), 4-2A-210, 4-2A-211(1), 4-2A-212(1), 4-2A-213, 4-2A-517(1)(b), 4-9-206 and 4-9-318).

#### Definitional Cross References:

"Cancellation". Section 2A-103(1)(b) (§ 4-2A-103(1)(b)).

"Consumer lease". Section 2A-103(1)(e) (§ 4-2A-103(1)(e)).

"Finance lease". Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Termination". Section 2A-103(1)(z) (§ 4-2A-103(1)(z)).

### Official Comment to Section 2A-501 (A.C.A. § 4-2A-501)

*Uniform Statutory Source:* Section 9-501 (§ 4-9-501).

*Changes:* Substantially revised.

#### Purposes:

1. Subsection (1) (§ 4-2A-501(1)) is new and represents a departure from the Article on Secured Transactions (Article 9) (§ 4-9-101 et seq.) as the subsection (§ 4-2A-501(1)) makes clear that whether a party to the lease agreement is in default is determined by this Article (§ 4-2A-101 et seq.) as well as the agreement. Sections 2A-508 and 2A-523 (§§ 4-2A-508 and 4-2A-523). It further departs from Article 9 (§ 4-9-101 et seq.) in recognizing the potential default of either party, a function of the bilateral nature of the obligations between the parties to the lease contract.

2. Subsection (2) (§ 4-2A-501(2)) is a version of the first sentence of Section 9-501(1) (§ 4-9-501(1)), revised to reflect leasing terminology.

3. Subsection (3) (§ 4-2A-501(3)), an

expansive version of the second sentence of Section 9-501(1) (§ 4-9-501(1)), lists the procedures that may be followed by the party seeking enforcement; in effect, the scope of the procedures listed in subsection (3) (§ 4-2A-501(3)) is consistent with the scope of the procedures available to the foreclosing secured party.

4. Subsection (4) (§ 4-2A-501(4)) establishes that the parties' rights and remedies are cumulative. *DeKoven, Leases of Equipment: Puritan Leasing Company v. August, A Dangerous Decision*, 12 U.S.F. L. Rev. 257, 276-80 (1978). Cumulation, and largely unrestricted selection, of remedies is allowed in furtherance of the general policy of the Commercial Code, stated in Section 1-106 (§ 4-1-106), that remedies be liberally administered to put the aggrieved party in as good a position as if the other party had fully performed. Therefore, cumulation of, or selection among, remedies is available to the extent necessary to put the aggrieved party in as good a position as it would have been in had there been full performance. How-



ever, cumulation of, or selection among, remedies is not available to the extent that the cumulation or selection would put the aggrieved party in a better position than it would have been in had there been full performance by the other party.

5. Section 9-501(3) (§ 4-9-501(3)), which, among other things, states that certain rules, to the extent they give rights to the debtor and impose duties on the secured party, may not be waived or varied, was not incorporated in this Article (§ 4-2A-101 et seq.). Given the significance of freedom of contract in the development of the common law as it applies to bailments for hire and the lessee's lack of an equity of redemption, there was no reason to impose that restraint.

*Cross References:*

Sections 1-106, 2A-508, 2A-523, Article 9, especially Sections 9-501(1) and

9-501(3) (§§ 4-1-106, 4-2A-508, 4-2A-523, 4-9-101 et seq., especially §§ 4-9-501(1) and 4-9-501(3)).

*Definitional Cross References:*

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

**Official Comment to Section 2A-502 (A.C.A. § 4-2A-502)**

*Uniform Statutory Source:* None.

*Purposes:* This section (§ 4-2A-502) makes clear that absent agreement to the contrary or provision in this Article (§ 4-2A-101 et seq.) to the contrary, e.g., Section 2A-516(3)(a) (§ 4-2A-516(3)(a)), the party in default is not entitled to notice of default or enforcement. While a review of Part 5 of Article 9 (§ 4-9-501 et seq.) leads to the same conclusion with respect to giving notice of default to the debtor, it is never stated. Although Article 9 (§ 4-9-101 et seq.) requires notice of disposition and strict foreclosure, the different scheme of lessors' and lessees' rights and remedies developed under the common law, and codified by this Article (§ 4-2A-101 et seq.), generally does not require notice of enforcement; furthermore, such notice is not mandated by due process requirements. However, certain sections

of this Article (§ 4-2A-101 et seq.) do require notice. E.g., Section 2A-517(2) (§ 4-2A-517(2)).

*Cross References:*

Sections 2A-516(3)(a), 2A-517(2), and Article 9, esp. Part 5 (§ 4-2A-516(3)(a), 4-2A-517(2), and 4-9-101 et seq., esp. 4-9-501 et seq.).

*Definitional Cross References:*

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notice". Section 1-201(25) (§ 4-1-201(25)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

**Official Comment to Section 2A-503 (A.C.A. § 4-2A-503)**

*Uniform Statutory Source:* Sections 2-719 and 2-701 (§§ 4-2-719 and 4-2-701).

*Changes:* Rewritten to reflect lease terminology and to clarify the relationship between this section (§ 4-2A-503) and Section 2A-504 (§ 4-2A-504).

*Purposes:*

1. A significant purpose of this Part

(§ 4-2A-501 et seq.) is to provide rights and remedies for those parties to a lease who fail to provide them by agreement or whose rights and remedies fail of their essential purpose or are unenforceable. However, it is important to note that this implies no restriction on freedom to contract. Sections 2A-103(4) and 1-102(3) (§§ 4-2A-103(4) and 4-1-102(3)). Thus,

subsection (1) (§ 4-2A-503(1)), a revised version of the provisions of Section 2-719(1) (§ 4-2-719(1)), allows the parties to the lease agreement freedom to provide for rights and remedies in addition to or in substitution for those provided in this Article (§ 4-2A-101 et seq.) and to alter or limit the measure of damages recoverable under this Article (§ 4-2A-101 et seq.). Except to the extent otherwise provided in this Article (§ 4-2A-101 et seq.) (e.g., Sections 2A-105, 106 and 108(1) and (2)) (§§ 4-2A-105, 106 and 108(1) and (2)), this Part (§ 4-2A-501 et seq.) shall be construed neither to restrict the parties' ability to provide for rights and remedies or to limit or alter the measure of damages by agreement, not to imply disapproval of rights and remedy schemes other than those set forth in this Part (§ 4-2A-501 et seq.).

2. Subsection (2) (§ 4-2A-503(2)) makes explicit with respect to this Article (§ 4-2A-101 et seq.) what is implicit in Section 2-719 (§ 4-2-719) with respect to the Article on Sales (Article 2) (§ 4-2-101 et seq.): if an exclusive remedy is head to be unconscionable, remedies under this Article (§ 4-2A-101 et seq.) are available. Section 2-719 (§ 4-2-719) official comment 1.

3. Subsection (3) (§ 4-2A-503(3)), a revision of Section 2-719(3) (§ 4-2-719(3)), makes clear that consequential damages may also be liquidated. Section 2A-504(1) (§ 4-2A-504(1)).

4. Subsection (4) (§ 4-2A-503(4)) is a revision of the provisions of Section 2-701 (§ 4-2-701). This subsection (§ 4-2A-503(4)) leaves the treatment of default with respect to obligations or promises collat-

eral or ancillary to the lease contract to other law. Sections 2A-103(4) and 1-103 (§§ 4-2A-103(4) and 4-1-103). An example of such an obligation would be that of the lessor to the secured creditor which has provided the funds to leverage the lessor's lease transaction; an example of such a promise would be that of the lessee, as seller, to the lessor, as buyer, in a saleleaseback transaction.

#### *Cross References:*

Sections 1-102(3), 1-103, Article 2, especially Sections 2-701, 2-719, 2-719(1), 2-719(3), 2-719 official comment 1, and Sections 2A-103(4), 2A-105, 2A-106, 2A-108(1), 2A-108(2), and 2A-504 (§§ 4-1-102(3), 4-1-103, 4-2-101 et seq., especially §§ 4-2-701, 4-2-719, 4-2-719(1), 4-2-719(3), 4-2-719 official comment 1, and §§ 4-2A-103(4), 4-2A-105, 4-2A-106, 4-2A-108(1), 4-2A-108(2), and 4-2A-504).

#### *Definitional Cross References:*

"Agreed". Section 1-201(3) (§ 4-1-201(3)).

"Consumer goods". Section 9-109(1) (§ 4-9-109(1)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

### **Official Comment to Section 2A-504 (A.C.A. § 4-2A-504)**

*Uniform Statutory Source:* Sections 2-718(1), (2), (3) and 2-719(2) (§§ 4-2-718(1), (2), (3) and 4-2-719(2)).

*Changes:* Substantially rewritten.

#### *Purposes:*

Many leasing transactions are predicated on the parties' ability to agree to an appropriate amount of damages or formula for damages in the event of default or other act or omission. The rule with respect to sales of goods (Section 2-718) (§ 4-2-718) may not be sufficiently flexible

to accommodate this practice. Thus, consistent with the common law emphasis upon freedom to contract with respect to bailments for hire, this section (§ 4-2A-504) has created a revised rule that allows greater flexibility with respect to leases of goods.

Subsection (1) (§ 4-2A-504(1)), a significantly modified version of the provisions of Section 2-718(1) (§ 4-2-718(1)), provides for liquidation of damages in the lease agreement at an amount or by a formula. Section 2-718(1) (§ 4-2-718(1))



does not by its express terms include liquidation by a formula; this change was compelled by modern leasing practice. Subsection (1) (§ 4-2A-504(1)), in a further expansion of Section 2-718(1) (§ 4-2-718(1)), provides for liquidation of damages for default as well as any other act or omission.

A liquidated damages formula that is common in leasing practice provides that the sum of lease payments past due, accelerated future lease payments, and the lessor's estimated residual interest, less the net proceeds of disposition (whether by sale or re-lease) of the leased goods is the lessor's damages. Tax indemnities, costs, interest and attorney's fees are also added to determine the lessor's damages. Another common liquidated damages formula utilizes a periodic depreciation allocation as a credit to the aforesaid amount in mitigation of a lessor's damages. A third formula provides for a fixed number of periodic payments as a means of liquidating damages. Stipulated loss or stipulated damage schedules are also common. Whether these formulae are enforceable will be determined in the context of each case by applying a standard of reasonableness in light of the harm anticipated when the formula was agreed to. Whether the inclusion of these formulae will affect the classification of the transaction as a lease or a security interest is to be determined by the facts of each case. Section 1-201(37) (§ 4-1-201(37)). E.g., *In re Noack*, 44 Bankr. 172, 174-75 (Bankr. E.D. Wis. 1984).

This section (§ 4-2A-504) does not incorporate two other tests that under sales law determine enforceability of liquidated damages, i.e., difficulties of proof of loss and inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. The ability to liquidate damages is critical to modern leasing practice; given the parties' freedom to contract at common law, the policy behind retaining these two additional requirements here was thought to be outweighed. Further, given the expansion of subsection (1) (§ 4-2A-504(1)) to enable the parties to liquidate the amount payable with respect to an indemnity for loss or diminution of anticipated tax benefits resulted in another change: the last sentence of Section 2-718(1) (§ 4-2-718(1)), providing that a term fixing unreasonably large liquidated damages is

void as a penalty, was also not incorporated. The impact of local, state and federal tax laws on a leasing transaction can result in an amount payable with respect to the tax indemnity many times greater than the original purchase price of the goods. By deleting the reference to unreasonably large liquidated damages the parties are free to negotiate a formula, restrained by the rule of reasonableness in this section (§ 4-2A-504). These changes should invite the parties to liquidate damages. Peters, *Remedies for Breach of Contracts Relating to the Sale of Goods Under the Uniform Commercial Code: A Roadmap for Article Two*, 73 Yale L.J. 199, 278 (1963).

Subsection (2) (§ 4-2A-504(2)), a revised version of Section 2-719(2) (§ 4-2-719(2)), provides that if the liquidated damages provision is not enforceable or fails of its essential purpose, remedy may be had as provided in this Article (§ 4-2A-101 et seq.).

Subsection (3)(b) of this section (§ 4-2A-504(3)(b)) differs from subsection (2)(b) of Section 2-718 (§ 4-2-718(2)(b)); in the absence of a valid liquidated damages amount or formula the lessor is permitted to retain 20 percent of the present value of the total rent payable under the lease. The alternative limitation of \$500 contained in Section 2-718 (§ 4-2-718) is deleted as unrealistically low with respect to a lease other than a consumer lease.

#### *Cross References:*

Sections 1-201(37), 2-718, 2-718(1), 2-718(2)(b) and 2-719(2) (§§ 4-1-201(37), 4-2-718, 4-2-718(1), 4-2-718(2)(b) and 4-2-719(2)).

#### *Definitional Cross References:*

"Consumer lease". Section 2A-103(1)(e) (§ 4-2A-103(1)(e)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Insolvent". Section 1-201(23) (§ 4-1-201(23)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Lessor's residual interest". Section 2A-103(1)(q) (§ 4-2A-103(1)(q)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Present value". Section 2A-103(1)(u) (§ 4-2A-103(1)(u)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Term". Section 1-201(42) (§ 4-1-201(42)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

### Official Comment to Section 2A-505 (A.C.A. § 4-2A-505)

*Uniform Statutory Source:* Sections 2-106(3) and (4), 2-720 and 2-721 (§§ 4-2-106(3) and (4), 4-2-720 and 4-2-721).

*Changes:* Revised to reflect leasing practices and terminology.

#### *Definitional Cross References:*

"Cancellation". Section 2A-103(1)(b) (§ 4-2A-103(1)(b)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Termination". Section 2A-103(1)(z) (§ 4-2A-103(1)(z)).

### Official Comment to Section 2A-506 (A.C.A. § 4-2A-506)

*Uniform Statutory Source:* Section 2-725 (§ 4-2-725).

*Changes:* Substantially rewritten.

#### *Purposes:*

Subsection (1) (§ 4-2A-506(1)) does not incorporate the limitation found in Section 2-725(1) (§ 4-2-725(1)) prohibiting the parties from extending the period of limitation. Breach of warranty and indemnity claims often arise in a lease transaction; with the passage of time such claims often diminish or are eliminated. To encourage the parties to commence litigation under these circumstances makes little sense.

Subsection (2) (§ 4-2A-506(2)) states two rules for determining when a cause of action accrues. With respect to default, the rule of Section 2-725(2) (§ 4-2-725(2)) is not incorporated in favor of a more liberal rule of the later of the date when

the default occurs or when the act or omission on which it is based is or should have been discovered. With respect to indemnity, a similarly liberal rule is adopted.

#### *Cross References:*

Sections 2-725(1) and 2-725(2) (§§ 4-2-725(1) and 4-2-725(2)).

#### *Definitional Cross References:*

"Action". Section 1-201(1) (§ 4-1-201(1)).

"Aggrieved party". Section 1-201(2) (§ 4-1-201(2)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Termination". Section 2A-103(1)(z) (§ 4-2A-103(1)(z)).

### Official Comment to Section 2A-507 (A.C.A. § 4-2A-507)

*Uniform Statutory Source:* Sections 2-723 and 2-724 (§§ 4-2-723 and 4-2-724).

*Changes:* Revised to reflect leasing practices and terminology. Sections 2A-519 and 2A-528 (§§ 4-2A-519 and 4-2A-528)

specify the times as of which market rent is to be determined.

#### *Definitional Cross References:*

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).



"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Notice". Section 1-201(25) (§ 4-1-201(25)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Usage of trade". Section 1-205 (§ 4-1-205).

"Value". Section 1-201(44) (§ 4-1-201(44)).

### Official Comment to Section 2A-508 (A.C.A. § 4-2A-508)

*Uniform Statutory Source: Sections 2-711 and 2-717 (§§ 4-2-711 and 4-2-717).*

*Changes:* Substantially rewritten.

#### *Purposes:*

1. This section (§ 4-2A-508) is an index to Sections 2A-509 through 522 (§§ 4-2A-509 — 522) which set out the lessee's rights and remedies after the lessor's default. The lessor and the lessee can agree to modify the rights and remedies available under this Article (§ 4-2A-101 et seq.); they can, among other things, provide that for defaults other than those specified in subsection (1) (§ 4-2A-508(1)) the lessee can exercise the rights and remedies referred to in subsection (1) (§ 4-2A-508(1)); and they can create a new scheme of rights and remedies triggered by the occurrence of the default. Sections 2A-103(4) and 1-102(3) (§§ 4-2A-103(4) and 4-1-102(3)).

2. Subsection (1) (§ 4-2A-508(1)), a substantially rewritten version of the provisions of Section 2-711(1) (§ 4-2-711(1)), lists three cumulative remedies of the lessee where the lessor has failed to deliver conforming goods or has repudiated the contract, or the lessee has rightfully rejected or justifiably revoked. Sections 2A-501(2) and (4) (§§ 4-2A-501(2) and (4)). Subsection (1) (§ 4-2A-508(1)) also allows the lessee to exercise any contractual remedy. This Article (§ 4-2A-101 et seq.) rejects any general doctrine of election of remedy. To determine if one remedy bars another in a particular case is a function of whether the lessee has been put in as good a position as if the lessor had fully performed the lease agreement. Use of multiple remedies is barred only if the effect is to put the lessee in a better position than it would have been in had the lessor fully performed under the lease. Sections 2A-103(4), 2A-501(4), and 1-106(1) (§§ 4-2A-103(4), 4-2A-501(4),

and 4-1-106(1)). Subsection (1)(b) (§ 4-2A-508(1)(b)), in recognition that no bright line can be created that would operate fairly in all installment lease cases and in recognition of the fact that a lessee may be able to cancel the lease (revoke acceptance of the goods) after the goods have been in use for some period of time, does not require that all lease payments made by the lessee under the lease be returned upon cancellation. Rather, only such portion as is just of the rent and security payments made may be recovered. If a defect in the goods is discovered immediately upon tender to the lessee and the goods are rejected immediately, then the lessee should recover all payments made. If, however, for example, a 36-month equipment lease is terminated in the 12th month because the lessor has materially breached the contract by failing to perform its maintenance obligations, it may be just to return only a small part or none of the rental payments already made.

3. Subsection (2) (§ 4-2A-508(2)), a version of the provisions of Section 2-711(2) (§ 4-2-711(2)) revised to reflect leasing terminology, lists two alternative remedies for the recovery of the goods by the lessee; however, each of these remedies is cumulative with respect to those listed in subsection (1) (§ 4-2A-508(1)).

4. Subsection (3) (§ 4-2A-508(3)) is new. It covers defaults which do not deprive the lessee of the goods and which are not so serious as to justify rejection or revocation of acceptance under subsection (1) (§ 4-2A-508(1)). It also covers defaults for which the lessee could have rejected or revoked acceptance of the goods but elects not to do so and retains the goods. In either case, a lessee which retains the goods is entitled to recover damages as stated in Section 2A-519(3) (§ 4-2A-519(3)). That measure of damages is "the loss resulting in the ordinary course of

events from the lessor's default as determined in any manner that is reasonable together with incidental and consequential damages, less expenses saved in consequence of the lessor's breach."

5. Subsection (1)(d) (§ 4-2A-508(1)(d)) and subsection (3) (§ 4-2A-508(3)) recognize that the lease agreement may provide rights and remedies in addition to or different from those which Article 2A (§ 4-2A-101 et seq.) provides. In particular, subsection (3) (§ 4-2A-508(3)) provides that the lease agreement may give the remedy of cancellation of the lease for defaults by the lessor that would not otherwise be material defaults which would justify cancellation under subsection (1) (§ 4-2A-508(1)). If there is a right to cancel, there is, of course, a right to reject or revoke acceptance of the goods.

6. Subsection (4) (§ 4-2A-508(4)) is new and merely adds to the completeness of the index by including a reference to the lessee's recovery of damages upon the lessor's breach of warranty; such breach may not rise to the level of a default by the lessor justifying revocation of acceptance. If the lessee properly rejects or revokes acceptance of the goods because of a breach of warranty, the rights and remedies are those provided in subsection (1) (§ 4-2A-508(1)) rather than those in Section 2A-519(4) (§ 4-2A-519(4)).

7. Subsection (5) (§ 4-2A-508(5)), a revised version of the provisions of Section 2-711(3) (§ 4-2-711(3)), recognizes, on rightful rejection or justifiable revocation, the lessee's security interest in goods in its possession and control. Section 9-113 (§ 4-9-113), which recognized security interests arising under the Article on Sales (Article 2) (§ 4-2-101 et seq.), was amended with the adoption of this Article (§ 4-2A-101 et seq.) to reflect the security interests arising under this Article (§ 4-2A-101 et seq.). Pursuant to Section 2A-511(4) (§ 4-2A-511(4)), a purchaser who purchases goods from the lessee in good faith takes free of any rights of the lessor, or in the case of a finance lease the supplier. Such goods, however, must have been rightfully rejected and disposed of pursuant to Section 2A-511 or 2A-512 (§ 4-2A-511 or 4-2A-512). However, Section 2A-517(5) (§ 4-2A-517(5)) provides that the lessee will have the same rights and duties with respect to goods where acceptance has been revoked as with respect to goods rejected. Thus, Section 2A-

511(4) (§ 4-2A-511(4)) will apply to the lessee's disposition of such goods.

8. Pursuant to Section 2A-527(5) (§ 4-2A-527(5)), the lessee must account to the lessor for the excess proceeds of such disposition, after satisfaction of the claim secured by the lessee's security interest.

9. Subsection (6) (§ 4-2A-508(6)), a slightly revised version of the provisions of Section 2-717 (§ 4-2-717), sanctions a right of set-off by the lessee, subject to the rule of Section 2A-407 (§ 4-2A-407) with respect to irrevocable promises in a finance lease that is not a consumer lease, and further subject to an enforceable "hell or high water" clause in the lease agreement. Section 2A-407 (§ 4-2A-407) official comment. No attempt is made to state how the set-off should occur; this is to be determined by the facts of each case.

10. There is no special treatment of the finance lease in this section (§ 4-2A-508). Absent supplemental principles of law and equity to the contrary, in the case of most finance leases, following the lessee's acceptance of the goods the lessee will have no rights or remedies against the lessor, because the lessor's obligations to the lessee are minimal. Sections 2A-210 and 2A-211(1) (§§ 4-2A-210 and 4-2A-211(1)). Since the lessee will look to the supplier for performance, this is appropriate. Section 2A-209 (§ 4-2A-209).

#### *Cross References:*

Sections 1-102(3), 1-103, 1-106(1), Article 2, especially Sections 2-711, 2-717 and Sections 2A-103(4), 2A-209, 2A-210, 2A-211(1), 2A-407, 2A-501(2), 2A-501(4), 2A-509 through 2A-522, 2A-511(3), 2A-517(5), 2A-527(5) and Section 9-113 §§ 4-1-102(3), 4-1-103, 4-1-106(1), 4-2-101 et seq., especially §§ 4-2-711, 4-2-717 and §§ 4-2A-103(4), 4-2A-209, 4-2A-210, 4-2A-211(1), 4-2A-407, 4-2A-501(2), 4-2A-501(4), 4-2A-509 — 4-2A-522, 4-2A-511(3), 4-2A-517(5), 4-2A-527(5) and § 4-9-113).

#### *Definitional Cross References:*

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Good faith". Sections 1-201(19) and 2-103(1)(b) (§§ 4-1-201(19) and 4-2-103(1)(b)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Installment lease contract". Section 2A-103(1)(i) (§ 4-2A-103(1)(i)).



"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notifies". Section 1-201(26) (§ 4-1-201(26)).

"Receipt". Section 2-103(1)(c) (§ 4-2-103(1)(c)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Security interest". Section 1-201(37) (§ 4-1-201(37)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

#### **Official Comment to Section 2A-509 (A.C.A. § 4-2A-509)**

*Uniform Statutory Source:* Sections 2-601 and 2-602(1) (§§ 4-2-601 and 4-2-602(1)).

*Changes:* Revised to reflect leasing practices and terminology.

##### *Definitional Cross References:*

"Commercial unit". Section 2A-103(1)(c) (§ 4-2A-103(1)(c)).

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Installment lease contract". Section 2A-103(1)(i) (§ 4-2A-103(1)(i)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notifies". Section 1-201(26) (§ 4-1-201(26)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Seasonably". Section 1-204(3) (§ 4-1-204(3)).

#### **Official Comment to Section 2A-510 (A.C.A. § 4-2A-510)**

*Uniform Statutory Source:* Section 2-612 (§ 4-2-612).

*Changes:* Revised to reflect leasing practices and terminology.

##### *Definitional Cross References:*

"Action". Section 1-201(1) (§ 4-1-201(1)).

"Aggrieved party". Section 1-201(2) (§ 4-1-201(2)).

"Cancellation". Section 2A-103(1)(b) (§ 4-2A-103(1)(b)).

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Installment lease contract". Section 2A-103(1)(i) (§ 4-2A-103(1)(i)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notifies". Section 1-201(26) (§ 4-1-201(26)).

"Seasonably". Section 1-204(3) (§ 4-1-204(3)).

"Supplier". Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

#### **Official Comment to Section 2A-511 (A.C.A. § 4-2A-511)**

*Uniform Statutory Source:* Sections 2-603 and 2-706(5) (§§ 4-2-603 and 4-2-706(5)).

*Changes:* Revised to reflect leasing practices and terminology. This section

(§ 1134-2A-511), by its terms, applies to merchants as well as others. Thus, in construing the section (§ 4-2A-511) it is important to note that under this Act (§ 4-1-101 et seq.) the term good faith is

defined differently for merchants (Section 2-103(1) (b)) (§ 4-2-103(1) (b)) than for others (Section 1-201(19)) (§ 4-1-201(19)). Section 2A-103(3) and (4) (§ 4-2A-103(3) and (4)).

*Definitional Cross References:*

"Action". Section 1-201(1) (§ 4-1-201(1)).

"Good faith". Sections 1-201(19) and 2-103(1)(b) (§§ 4-1-201(19) and 4-2-103(1)(b)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Merchant lessee". Section 2A-103(1)(t) (§ 4-2A-103(1)(t)).

"Purchaser". Section 1-201(33) (§ 4-1-201(33)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Security interest". Section 1-201(37) (§ 4-1-201(37)).

"Supplier". Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

**Official Comment to Section 2A-512 (A.C.A. § 4-2A-512)**

*Uniform Statutory Source:* Sections 2-602(2)(b) and (c) and 2-604 (§§ 4-2-602(2)(b) and (c) and 4-2-604).

*Changes:* Substantially rewritten.

*Purposes:* The introduction to subsection (1) (§ 4-2A-512(1)) references goods that threaten to decline in value speedily and not perishables, the reference in Section 2-604 (§ 4-2-604), the statutory analogue. This is a change in style, not substance, as the first phrase includes the second. Subparagraphs (a) and (c) (§ 4-2A-512(a) and (c)) are revised versions of the provisions of Section 2-602(2)(b) and (c) (§ 4-2-602(2)(b) and (c)). Subparagraph (a) (§ 4-2A-512(1)(a)) states the rule with respect to the lessee's treatment of goods in its possession following rejection; subparagraph (b) (§ 4-2A-512(1)(b)) states the rule regarding such goods if the lessor or supplier then fails to give instructions to the lessee. If the lessee performs in a fashion consistent with subparagraphs (a) and (b) (§ 4-2A-512(1)(a) and (b)), subparagraph (c) (§ 4-2A-512(1)(c)) exonerates the lessee.

*Cross References:*

Sections 2-602(2)(b), 2-602(2)(c) and 2-604 (§§ 4-2-602(2)(b), 4-2-602(2)(c) and 4-2-604).

*Definitional Cross References:*

"Action". Section 1-201(1) (§ 4-1-201(1)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notification". Section 1-201(26) (§ 4-1-201(26)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Seasonably". Section 1-204(3) (§ 4-1-204(3)).

"Security interest". Section 1-201(37) (§ 4-1-201(37)).

"Supplier". Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

**Official Comment to Section 2A-513 (A.C.A. § 4-2A-513)**

*Uniform Statutory Source:* Section 2-508 (§ 4-2-508).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).



"Money". Section 1-201(24) (§ 4-1-201(24)).

"Notifies". Section 1-201(26) (§ 4-1-201(26)). "Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Seasonably". Section 1-204(3) (§ 4-1-204(3)).

"Supplier". Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

### Official Comment to Section 2A-514 (A.C.A. § 4-2A-514)

*Uniform Statutory Source:* Section 2-605 (§ 4-2-605).

*Changes:* Revised to reflect leasing practices and terminology.

*Purposes:* The principles applicable to the commercial practice of payment against documents (subsection 2) (§ 4-2A-514(2)) are explained in official comment 4 to Section 2-605 (§ 4-2-605), the statutory analogue to this section (§ 4-2A-514).

*Cross References:*

Section 2-605 official comment 4 (§ 4-2-605 official comment 4).

*Definitional Cross References:*

"Between merchants". Section 2-104(3) (§ 4-2-104(3)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Seasonably". Section 1-204(3) (§ 4-1-204(3)).

"Supplier". Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

"Writing". Section 1-201(46) (§ 4-1-201(46)).

### Official Comment to Section 2A-515 (A.C.A. § 4-2A-515)

*Uniform Statutory Source:* Section 2-606 (§ 4-2-606).

*Changes:* The provisions of Section 2-606(1)(a) (§ 4-2-606(1)(a)) were substantially rewritten to provide that the lessee's conduct may signify acceptance. Further, the provisions of Section 2-606(1)(c) (§ 4-2-606(1)(c)) were not incorporated as irrelevant given the lessee's possession and use of the leased goods.

*Cross References:*

Sections 2-606(1)(a) and 2-606(1)(c) (§§ 4-2-606(1)(a) and 4-2-606(1)(c)).

*Definitional Cross References:*

"Commercial unit". Section 2A-103(1)(c) (§ 4-2A-103(1)(c)).

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Supplier". Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

### Official Comment to Section 2A-516 (A.C.A. § 4-2A-516)

*Uniform Statutory Source:* Section 2-607 (§ 4-2-607).

*Changes:* Substantially revised.

*Purposes:*

1. Subsection (2) (§ 4-2A-516(2)) creates a special rule for finance leases, precluding revocation if acceptance is made with knowledge of nonconformity with respect to the lease agreement, as opposed to the supply agreement; this is not inequ-

itable as the lessee has a direct claim against the supplier. Section 2A-209(1) (§ 4-2A-209(1)). Revocation of acceptance of a finance lease is permitted if the lessee's acceptance was without discovery of the nonconformity (with respect to the lease agreement, not the supply agreement) and was reasonably induced by the lessor's assurances. Section 2A-517(1)(b) (§ 4-2A-517(1)(b)). Absent exclusion or modification, the lessor under a finance

lease makes certain warranties to the lessee. Sections 2A-210 and 2A-211(1) (§§ 4-2A-210 and 4-2A-211(1)). Revocation of acceptance is not prohibited even after the lessee's promise has become irrevocable and independent. Section 2A-407 (§ 4-2A-407) official comment. Where the finance lease creates a security interest, the rule may be to the contrary. *General Elec. Credit Cord. of Tennessee v. Ger-Beck Mach. Co.*, 806 F.2d 1207 (3rd Cir. 1986).

2. Subsection (3) (a) (§ 4-2A-516(3)(a)) requires the lessee to give notice of default, within a reasonable time after the lessee discovered or should have discovered the default. In a finance lease, notice may be given either to the supplier, the lessor, or both, but remedy is barred against the party not notified. In a finance lease, the lessor is usually not liable for defects in the goods and the essential notice is to the supplier. While notice to the finance lessor will often not give any additional rights to the lessee, it would be good practice to give the notice since the finance lessor has an interest in the goods. Subsection (3) (a) (§ 4-2A-516(3)(a)) does not use the term finance lease, but the definition of supplier is a person from whom a lessor buys or leases goods to be leased under a finance lease. Section 2A-103(1)(x) (§ 4-2A-103(1)(x)). Therefore, there can be a "supplier" only in a finance lease. Subsection (4) (§ 4-2A-516(4)) applies similar notice rules as to lessors and supplier if a lessee is sued for a breach of warranty or other obligation for which a lessor or supplier is answerable over.

3. Subsection (3)(b) (§ 4-2A-516(3)(b)) requires the lessee to give the lessor notice of litigation for infringement or the like. There is an exception created in the case of a consumer lease. While such an exception was considered for a finance lease, it was not created because it was not necessary - the lessor in a finance lease does not give a warranty against infringement. Section 2A-211(2) (§ 4-2A-211(2)). Even though not required under subsection (3)(b) (§ 4-2A-516(3)(b)), the lessee who takes under a finance lease should consider giving notice of litigation for infringement or the like to the supplier, because the lessee obtains the benefit of the suppliers' promises subject to the suppliers' defenses or claims. Sections 2A-

209(1) and 2-607(3)(b) (§§ 4-2A-209(1) and 4-2-607(3)(b)).

#### *Cross References:*

Sections 2-607(3)(b), 2A-103(1)(x), 2A-209(1), 2A-210, 2A-211(1), 2A-211(2), 2A-407 official comment and 2A-517(1)(b) (§§ 4-2-607(3)(b), 4-2A-103(1)(x), 4-2A-209(1), 4-2A-210, 4-2A-211(1), 4-2A-211(2), 4-2A-407 official comment and 4-2A-517(1)(b)).

#### *Definitional Cross References:*

"Action". Section 1-201(1) (§ 4-1-201(1)).

"Agreement". Section 1-201(3) (§ 4-1-201(3)).

"Burden of establishing". Section 1-201(8) (§ 4-1-201(8)).

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Consumer lease". Section 2A-103(1)(e) (§ 4-2A-103(1)(e)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Discover". Section 1-201(25) (§ 4-1-201(25)).

"Finance lease". Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Knowledge". Section 1-201(25) (§ 4-1-201(25)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notice". Section 1-201(25) (§ 4-1-201(25)).

"Notifies". Section 1-201(26) (§ 4-1-201(26)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Receipt". Section 2-103(1)(c) (§ 4-2-103(1)(c)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Seasonably". Section 1-204(3) (§ 4-1-204(3)).

"Supplier". Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

"Written". Section 1-201(46) (§ 4-1-201(46)).



**Official Comment to Section 2A-517 (A.C.A. § 4-2A-517)**

*Uniform Statutory Source:* Section 2-608 (§ 4-2-608).

*Changes:* Revised to reflect leasing practices and terminology. Note that in the case of a finance lease the lessee retains a limited right to revoke acceptance. Sections 2A-517(1) (b) and 2A-516 (§§ 4-2A-517(1) (b) and 4-2A-516) official comment. New subsections (2) and (3) (§ 4-2A-517(2) and (3)) added.

*Purposes:*

1. The section (§ 4-2A-517) states the situations under which the lessee may return the goods to the lessor and cancel the lease. Subsection (2) (§ 4-2A-517(2)) recognizes that the lessor may have continuing obligations under the lease and that a default as to those obligations may be sufficiently material to justify revocation of acceptance of the leased items and cancellation of the lease by the lessee. For example, a failure by the lessor to fulfill its obligation to maintain leased equipment or to supply other goods which are necessary for the operation of the leased equipment may justify revocation of acceptance and cancellation of the lease.

2. Subsection (3) (§ 4-2A-517(3)) specifically provides that the lease agreement may provide that the lessee can revoke acceptance for defaults by the lessor which in the absence of such an agreement might not be considered sufficiently serious to justify revocation. That is, the

parties are free to contract on the question of what defaults are so material that the lessee can cancel the lease.

*Cross Reference:*

Section 2A-516 official comment (§ 4-2A-516 official comment).

*Definitional Cross References:*

"Commercial unit". Section 2A-103(1)(c) (§ 4-2A-1(13)(1)(c)).

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Discover". Section 1-201(25) (§ 4-1-201(25)).

"Finance lease". Section 2A-103(1)(g) (§ 4-2A-103(1)(g)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Lot". Section 2A-103(1)(s) (§ 4-2A-103(1)(s)).

"Notifies". Section 1-201(26) (§ 4-1-201(26)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Seasonably". Section 1-204(3) (§ 4-1-204(3)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

**Official Comment to Section 2A-518 (A.C.A. § 4-2A-518)**

*Uniform Statutory Source:* Section 2-712 (§ 4-2-712).

*Changes:* Substantially revised.

*Purposes:*

1. Subsection (1) (§ 4-2A-518(1)) allows the lessee to take action to fix its damages after default by the lessor. Such action may consist of the lease of goods. The decision to cover is a function of commercial judgment, not a statutory mandate replete with sanctions for failure to comply. Cf. Section 9-507 (§ 4-9-507).

2. Subsection (2) (§ 4-2A-518(2)) states a rule for determining the amount of lessee's damages provided that there is no agreement to the contrary. The lessee's damages will be established using the new

lease agreement as a measure if the following three criteria are met: (i) the lessee's cover is by lease agreement, (ii) the lease agreement is substantially similar to the original lease agreement, and (iii) such cover was effected in good faith, and in a commercially reasonable manner. Thus, the lessee will be entitled to recover from the lessor the present value, as of the date of commencement of the term of the new lease agreement, of the rent under the new lease agreement applicable to that period which is comparable to the then remaining term of the original lease agreement less the present value of the rent reserved for the remaining term under the original lease, together with incidental or consequential damages less ex-

penses saved in consequence of the lessor's default. Consequential damages may include loss suffered by the lessee because of deprivation of the use of the goods during the period between the default and the acquisition of the goods under the new lease agreement. If the lessee's cover does not satisfy the criteria of subsection (2) (§ 4-2A-518(2)), Section 2A-519 (§ 4-2A-519) governs.

3. Two of the three criteria to be met by the lessee are familiar, but the concept of the new lease agreement being substantially similar to the original lease agreement is not. Given the many variables facing a party who intends to lease goods and the rapidity of change in the market place, the policy decision was made not to draft with specificity. It was thought unwise to seek to establish certainty at the cost of fairness. Thus, the decision of whether the new lease agreement is substantially similar to the original will be determined case by case.

4. While the section (§ 4-2A-518) does not draw a bright line, it is possible to describe some of the factors that should be considered in finding that a new lease agreement is substantially similar to the original. First, the goods subject to the new lease agreement should be examined. For example, in a lease of computer equipment the new lease might be for more modern equipment. However, it may be that at the time of the lessor's breach it was not possible to obtain the same type of goods in the market place. Because the lessee's remedy under Section 2A-519 (§ 4-2A-519) is intended to place the lessee in essentially the same position as if he had covered, if goods similar to those to have been delivered under the original lease are not available, then the computer equipment in this hypothetical should qualify as a commercially reasonable substitute. See Section 2-712(1) (§ 4-2-712(1)).

5. Second, the various elements of the new lease agreement should also be examined. Those elements include the presence, or absence of options to purchase or release; the lessor's representations, warranties and covenants to the lessee, as well as those to be provided by the lessee to the lessor; and the services, if any, to be provided by the lessor or by the lessee. All of these factors allocate cost and risk between the lessor and the lessee and thus affect the amount of rent to be paid.

If the differences between the original lease and the new lease can be easily valued, it would be appropriate for a court to adjust the difference in rental to take account of the difference between the two leases, find that the new lease is substantially similar to the old lease, and award cover damages under this section (§ 4-2A-518). If, for example, the new lease requires the lessor to insure the goods in the hands of the lessee, while the original lease required the lessee to insure, the usual cost of such insurance could be deducted from the rent due under the new lease before determining the difference in rental between the two leases.

6. Having examined the goods and the agreement, the test to be applied is whether, in light of these comparisons, the new lease agreement is substantially similar to the original lease agreement. These findings should not be made with scientific precision, as they are a function of economics, nor should they be made independently with respect to the goods and each element of the agreement, as it is important that a sense of commercial judgment pervade the finding. To establish the new lease as a proper measure of damage under subsection (2) (§ 4-2A-518(2)), these factors, taken as a whole, must result in a finding that the new lease agreement is substantially similar to the original.

7. A new lease can be substantially similar to the original lease even though its term extends beyond the remaining term of the original lease, so long as both (a) the lease terms are commercially comparable (e.g., it is highly unlikely that a one-month rental and a five-year lease would reflect similar commercial realities), and (b) the court can fairly apportion a part of the rental payments under the new lease to that part of the term of the new lease which is comparable to the remaining lease term under the original lease. Also, the lease term of the new lease may be comparable to the term of the original lease even though the beginning and ending dates of the two leases are not the same. For example, a two-month lease of agricultural equipment for the months of August and September may be comparable to a two-month lease running from the 15th of August to the 15th of October if in the particular location two-month leases beginning on August 15th are basically interchangeable with two-month



leases beginning August 1st. Similarly, the term of a one-year truck lease beginning on the 15th of January may be comparable to the term of a one-year truck lease beginning January 2d. If the lease terms are found to be comparable, the court may base cover damages on the entire difference between the costs under the two leases.

*Cross References:*

Sections 2-712(1), 2A-519 and 9-507 (§§ 4-2-712(1), 4-2A-519 and 4-9-507).

*Definitional Cross References:*

"Agreement". Section 1-201(3) (§ 4-1-201(3)).

"Contract". Section 1-201(11) (§ 4-1-201(11)).

"Good faith". Sections 1-201(19) and 2-103(1)(b) (§§ 4-1-201(19) and 4-2-103(1)(b)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Present value". Section 2A-103(1)(u) (§ 4-2A-103(1)(u)).

"Purchase". Section 2A-103(1)(v) (§ 4-2A-103(1)(v)).

**Official Comment to Section 2A-519 (A.C.A. § 4-2A-519)**

*Uniform Statutory Source:* Sections 2-713 and 2-714 (§§ 4-2-713 and 4-2-714).

*Changes:* Substantially revised.

*Purposes:*

1. Subsection (1) (§ 4-2A-519(1)), a revised version of the provisions of Section 2-713(1) (§ 4-2-713(1)), states the basic rule governing the measure of lessee's damages for non-delivery or repudiation by the lessor or for rightful rejection or revocation of acceptance by the lessee. This measure will apply, absent agreement to the contrary, if the lessee does not cover or if the cover does not qualify under Section 2A-518 (§ 4-2A-518). There is no sanction for cover that does not qualify.

2. The measure of damage is the present value, as of the date of default, of the market rent for the remaining term of the lease less the present value of the original rent for the remaining term of the lease, plus incidental and consequential damages less expenses saved in consequence of the default. Note that the reference in Section 2A-519(1) (s 4-2A-519(1)) is to the date of default not to the date of an event of default. An event of default under a lease agreement becomes a default under a lease agreement only after the expiration of any relevant period of grace and compliance with any notice requirements under this Article (§ 4-2A-101

et seq.) and the lease agreement. American Bar Foundation, *Commentaries on Indentures*, § 5-1, at 216-217 (1971). Section 2A-501(1) (§ 4-2A-501(1)). This conclusion is also a function of whether, as a matter of fact or law, the event of default has been waived, suspended or cured. Sections 2A-103(4) and 1-103 (§§ 4-2A-103(4) and 4-1-103).

3. Subsection (2) (§ 4-2A-519(2)), a revised version of the provisions of Section 2-713 (2) (§ 4-2-713(2)), states the rule with respect to determining market rent.

4. Subsection (3) (§ 4-2A-519(3)), a revised version of the provisions of Section 2-714(1) and (3) (§ 4-2-714(1) and (3)), states the measure of damages where goods have been accepted and acceptance is not revoked. The subsection (§ 4-2A-519(3)) applies both to defaults which occur at the inception of the lease and to defaults which occur subsequently, such as failure to comply with an obligation to maintain the leased goods. The measure in essence is the loss, in the ordinary course of events, flowing from the default.

5. Subsection (4) (§ 4-2A-519(4)), a revised version of the provisions of Section 2-714(2) (§ 4-2-714(2)), states the measure of damages for breach of warranty. The measure in essence is the present value of the difference between the value of the goods accepted and of the goods if they had been as warranted.

6. Subsections (1), (3) and (4) (§ 4-2A-519(1), (3) and (4)) specifically state that the parties may by contract vary the damages rules stated in those subsections (§ 4-2A-519(1), (3) and (4)).

*Cross References:*

Sections 2-713(1), 2-713(2), 2-714 and Section 2A-518 (§§ 4-2-713(1), 4-2-713(2), 4-2-714 and § 4-2A-518).

*Definitional Cross References:*

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notification". Section 1-201(26) (§ 4-1-201(26)).

"Present value". Section 2A-103(1)(u) (§ 4-2A-103(1)(u)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

**Official Comment to Section 2A-520 (A.C.A. § 4-2A-520)**

*Uniform Statutory Source:* Section 2-715 (§ 4-2-715).

*Changes:* Revised to reflect leasing terminology and practices.

*Purposes:*

Subsection (1) (§ 4-2A-520(1)), a revised version of the provisions of Section 2-715(1) (§ 4-2-715(1)), lists some examples of incidental damages resulting from a lessor's default; the list is not exhaustive. Subsection (1) (§ 4-2A-520(1)) makes clear that it applies not only to rightful rejection, but also to justifiable revocation.

Subsection (2) (§ 4-2A-520(2)), a revised version of the provisions of Section 2-715(2) (§ 4-2-715(2)), lists some examples of consequential damages resulting

from a lessor's default; the list is not exhaustive.

*Cross References:*

Section 2-715 (§ 4-2-715).

*Definitional Cross References:*

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Knows". Section 1-201(25) (§ 4-1-201(25)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Receipt". Section 2-103(1)(c) (§ 4-2-103(1)(c)).

**Official Comment to Section 2A-521 (A.C.A. § 4-2A-521)**

*Uniform Statutory Source:* Section 2-716 (§ 4-2-716).

*Changes:* Revised to reflect leasing practices and terminology, and to expand the reference to the right of replevin in subsection (3) (§ 4-2A-521(3)) to include other similar rights of the lessee.

*Definitional Cross References:*

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Term". Section 1-201(42) (§ 4-1-201(42)).



**Official Comment to Section 2A-522 (A.C.A. § 4-2A-522)**

*Uniform Statutory Source:* Section 2-502 (§ 4-2-502).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

“Conforming”. Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

“Goods”. Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

“Insolvent”. Section 1-201(23) (§ 4-1-201(23)).

“Lease contract”. Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

“Lessee”. Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

“Lessor”. Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

“Receipt”. Section 2-103(1)(c) (§ 4-2-103(1)(c)).

“Rights”. Section 1-201(36) (§ 4-1-201(36)).

**Official Comment to Section 2A-523 (A.C.A. § 4-2A-523)**

*Uniform Statutory Source:* Section 2-703 (§ 4-2-703).

*Changes:* Substantially revised.

*Purposes:*

1. Subsection (1) (§ 4-2A-523(1)) is an index to Sections 2A-524 through 2A-531 (§§ 4-2A-524 — 4-2A-531) and states that the remedies provided in those sections (§§ 4-2A-524 — 4-2A-531) are available for the defaults referred to in subsection (1) (§ 4-2A-523(1)): wrongful rejection or revocation of acceptance, failure to make a payment when due, or repudiation. In addition, remedies provided in the lease contract are available. Subsection (2) (§ 4-2A-523(2)) sets out a remedy if the lessor does not pursue to completion a right or actually obtain a remedy available under subsection (1) (§ 4-2A-523(1)), and subsection (3) (§ 4-2A-523(3)) sets out statutory remedies for defaults not specifically referred to in subsection (1) (§ 4-2A-523(1)). Subsection (3) (§ 4-2A-523(3)) provides that, if any default by the lessee other than those specifically referred to in subsection (1) (§ 4-2A-523(1)) is material, the lessor can exercise the remedies provided in subsection (1) or (2) (§ 4-2A-523(1) or (2)); otherwise the available remedy is as provided in subsection (3) (§ 4-2A-523(3)). A lessor who has brought an action seeking or has nonjudicially pursued one or more of the remedies available under subsection (1) (§ 4-2A-523(1)) may amend so as to claim or may nonjudicially pursue a remedy under subsection (2) (§ 4-2A-523(2)) unless the right or remedy first chosen has been pursued to an extent actually inconsistent with the new course of action. The intent of the provision (§ 4-2A-523) is to reject

the doctrine of election of remedies and to permit an alteration of course by the lessor unless such alteration would actually have an effect on the lessee that would be unreasonable under the circumstances. Further, the lessor may pursue remedies under both subsections (1) and (2) (§ 4-2A-523(1) and (2)) unless doing so would put the lessor in a better position than it would have been in had the lessee fully performed.

2. The lessor and the lessee can agree to modify the rights and remedies available under the Article (§ 4-2A-101 et seq.); they can, among other things, provide that for defaults other than those specified in subsection (1) (§ 4-2A-523(1)) the lessor can exercise the rights and remedies referred to in subsection (1) (§ 4-2A-523(1)), whether or not the default would otherwise be held to substantially impair the value of the lease contract to the lessor; they can also create a new scheme of rights and remedies triggered by the occurrence of the default. Sections 2A-103(4) and 1-102(3) (§§ 4-2A-103(4) and 4-1-102(3)).

3. Subsection (1) (§ 4-2A-523(1)), a substantially rewritten version of Section 2-703 (§ 4-2-703), lists various cumulative remedies of the lessor where the lessee wrongfully rejects or revokes acceptance, fails to make a payment when due, or repudiates. Section 2A-501(2) and (4) (§ 4-2A-501(2) and (4)). The subsection (§ 4-2A-523(1)) also allows the lessor to exercise any contractual remedy.

4. This Article (§ 4-2A-101 et seq.) rejects any general doctrine of election of remedy. Whether, in a particular case, one remedy bars another, is a function of whether lessor has been put in as good a

position as if the lessee had fully performed the lease contract. Multiple remedies are barred only if the effect is to put the lessor in a better position than it would have been in had the lessee fully performed under the lease. Sections 2A-103(4), 2A-501(4), and 1-106(1) (§§ 4-2A-103(4), 4-2A-501(4), and 4-1-106(1)).

5. Hypothetical: To better understand the application of subparagraphs (a) through (e) (§ 4-2A-523(1)(a) — (e)), it is useful to review a hypothetical. Assume that A is a merchant in the business of selling and leasing new bicycles of various types. B is about to engage in the business of subleasing bicycles to summer residents of and visitors to an island resort. A, as lessor, has agreed to lease 60 bicycles to B. While there is one master lease, deliveries and terms are staggered. 20 bicycles are to be delivered by A to B's island location on June 1; the term of the lease of these bicycles is four months. 20 bicycles are to be delivered by A to B's island location on July 1; the term of the lease of these bicycles is three months. Finally, 20 bicycles are to be delivered by A to B's island location on August 1; the term of the lease of these bicycles is two months. B is obligated to pay rent to A on the 15th day of each month during the term for the lease. Rent is \$50 per month, per bicycle. B has no option to purchase or release and must return the bicycles to A at the end of the term, in good condition, reasonable wear and tear excepted. Since the retail price of each bicycle is \$400 and bicycles used in the retail rental business have a useful economic life of 36 months, this transaction creates a lease. Sections 2A-103(1)(j) and 1-201(37) (§§ 4-2A-103(1)(j) and 4-1-201(37)).

6. A's current inventory of bicycles is not large. Thus, upon signing the lease with B in February, A agreed to purchase 60 new bicycles from A's principal manufacturer, with special instructions to drop ship the bicycles to B's island location in accordance with the delivery schedule set forth in the lease.

7. The first shipment of 20 bicycles was received by B on May 21. B inspected the bicycles, accepted the same as conforming to the lease and signed a receipt of delivery and acceptance. However, due to poor weather that summer, business was terrible and B was unable to pay the rent due on June 15. Pursuant to the lease A sent B

notice of default and proceeded to enforce his rights and remedies against B.

8. A's counsel first advised A that under Section 2A-510(2) (§ 4-2A-510(2)) and the terms of the lease B's failure to pay was a default with respect to the whole. Thus, to minimize A's continued exposure, A was advised to take possession of the bicycles. If A had possession of the goods A could refuse to deliver. Section 2A-525(1) (§ 4-2A-525(1)). However, the facts here are different. With respect to the bicycles in B's possession, A has the right to take possession of the bicycles, without breach of the peace. Section 2A-525(2) (§ 4-2A-525(2)). If B refuses to allow A access to the bicycles, A can proceed by action, including replevin or injunctive relief.

9. With respect to the 40 bicycles that have not been delivered, this Article (§ 4-2A-101 et seq.) provides various alternatives. First, assume that 20 of the remaining 40 bicycles have been manufactured and delivered by the manufacturer to a carrier for shipment to B. Given the size of the shipment, the carrier was using a small truck for the delivery and the truck had not yet reached the island ferry when the manufacturer (at the request of A) instructed the carrier to divert the shipment to A's place of business. A's right to stop delivery is recognized under these circumstances. Section 2A-526(1) (§ 4-2A-526(1)). Second, assume that the 20 remaining bicycles were in the process of manufacture when B defaulted. A retains the right (as between A as lessor and B as lessee) to exercise reasonable commercial judgment whether to complete manufacture or to dispose of the unfinished goods for scrap. Since A is not the manufacturer and A has a binding contract to buy the bicycles, A elected to allow the manufacturer to complete the manufacture of the bicycles, but instructed the manufacturer to deliver the completed bicycles to A's place of business. Section 2A-524(2) (§ 4-2A-524(2)).

10. Thus, so far A has elected to exercise the remedies referred to in subparagraphs (b) through (d) in subsection (1) (§ 4-2A-523(1)(b) — (d)). None of these remedies bars any of the others because A's election and enforcement merely resulted in A's possession of the bicycles. Had B performed A would have recovered possession of the bicycles. Thus A is in the process of obtaining the benefit of his



bargain. Note that A could exercise any other rights or pursue any other remedies provided in the lease contract (Section 2A-523(1) (f)) (§ 4-2A-523(1) (f)), or elect to recover his loss due to the lessee's default under Section 2A-523(2) (§ 4-2A-523(2)).

11. A's counsel next would determine what action, if any, should be taken with respect to the goods. As stated in subparagraph (e) (§ 4-2A-523(1)(e)) and as discussed fully in Section 2A-527(1) (§ 4-2A-527(1)) the lessor may, but has no obligation to, dispose of the goods by a substantially similar lease (indeed, the lessor has no obligation whatsoever to dispose of the goods at all) and recover damages based on that action, but lessor will not be able to recover damages which put it in a better position than performance would have done, nor will it be able to recover damages for losses which it could have reasonably avoided. In this case, since A is in the business of leasing and selling bicycles, A will probably inventory the 60 bicycles for its retail trade.

12. A's counsel then will determine which of the various means of ascertaining A's damages against B are available. Subparagraph (e) catalogues each relevant section. First, under Section 2A-527(2) (§ 4-2A-527(2)) the amount of A's claim is computed by comparing the original lease between A and B with any subsequent lease of the bicycles but only if the subsequent lease is substantially similar to the original lease contract. While the section (§ 4-2A-523) does not define this term, the official comment does establish some parameters. If, however, A elects to lease the bicycles to his retail trade, it is unlikely that the resulting lease will be substantially similar to the original, as leases to retail customers are considerably different from leases to wholesale customers like B. If, however, the leases were substantially similar, the damage claim is for accrued and unpaid rent to the beginning of the new lease, plus the present value as of the same date, of the rent reserved under the original lease for the balance of its term less the present value as of the same date of the rent reserved under the replacement lease for a term comparable to the balance of the term of the original lease, together with incidental damages less expenses saved in consequence of the lessee's default.

13. If the new lease is not substantially similar or if A elects to sell the bicycles or to hold the bicycles, damages are computed under Section 2A-528 or 2A-529 (§ 4-2A-528 or 4-2A-529).

14. If A elects to pursue his claim under Section 2A-528(1) (§ 4-2A-528(1)) the damage rule is the same as that stated in Section 2A-527(2) (§ 4-2A-527(2)) except that damages are measured from default if the lessee never took possession of the goods or from the time when the lessor did or could have regained possession and that the standard of comparison is not the rent reserved under a substantially similar lease entered into by the lessor but a market rent, as defined in Section 2A-507 (§ 4-2A-507). Further, if the facts of this hypothetical were more elaborate A may be able to establish that the measure of damage under subsection (1) (§ 4-2A-523(1)) is inadequate to put him in the same position that B's performance would have, in which case A can claim the present value of his lost profits.

15. Yet another alternative for computing A's damage claim against B which will be available in some situations is recovery of the present value, as of entry of judgment, of the rent for the then remaining lease term under Section 2A-529 (§ 4-2A-529). However, this formulation is not available if the goods have been repossessed or tendered back to A. For the 20 bicycles repossessed and the remaining 40 bicycles, A will be able to recover the present value of the rent only if A is unable to dispose of them, or circumstances indicate the effort will be unavailing. If A has prevailed in an action for the rent, at any time up to collection of a judgment by A against B, A might dispose of the bicycles. In such case A's claim for damages against B is governed by Section 2A-527 or 2A-528 (§ 4-2A-527 or 4-2A-528). Section 2A-529(3) (§ 4-2A-529(3)). The resulting recalculation of claim should reduce the amount recoverable by A against B and the lessor is required to cause an appropriate credit to be entered against the earlier judgment. However, the nature of the post-judgment proceedings to resolve this issue, and the sanctions for a failure to comply, if any-, will be determined by other law.

16. Finally, if the lease agreement had so provided pursuant to subparagraph (f) (§ 4-2A-523(1)(f)), A's claim against B

would not be determined under any of these statutory formulae, but pursuant to a liquidated damages clause. Section 2A-504(1) (§ 4-2A-504(1)).

17. These various methods of computing A's damage claim against B are alternatives subject to Section 2A-501(4) (§ 4-2A-501(4)). However, the pursuit of any one of these alternatives is not a bar to, nor has it been barred by, A's earlier action to obtain possession of the 60 bicycles. These formulae, which vary as a function of an overt or implied mitigation of damage theory, focus on allowing A a recovery of the benefit of his bargain with B. Had B performed, A would have received the rent as well as the return of the 60 bicycles at the end of the term.

18. Finally, A's counsel should also advise A of his right to cancel the lease contract under subparagraph (a) (§ 4-2A-523(1)(a)). Section 2A-505(1) (§ 4-2A-505(1)). Cancellation will discharge all existing obligations but preserve A's rights and remedies.

19. Subsection (2) (§ 4-2A-523(2)) recognizes that a lessor who is entitled to exercise the rights or to obtain a remedy granted by subsection (1) (§ 4-2A-523(1)) may choose not to do so. In such cases, the lessor can recover damages as provided in subsection (2) (§ 4-2A-523(2)). For example, for non-payment of rent, the lessor may decide not to take possession of the goods and cancel the lease, but rather to merely sue for the unpaid rent as it comes due plus lost interest or other damages "determined in any reasonable manner." Subsection (2) (§ 4-2A-523(2)) also negates any loss of alternative rights and remedies by reason of having invoked or commenced the exercise or pursuit of any one or more rights or remedies.

20. Subsection (3) (§ 4-2A-523(3)) allows the lessor access to a remedy scheme provided in this Article (§ 4-2A-101 et seq.) as well as that contained in the lease contract if the lessee is in default for reasons other than those stated in subsection (1) (§ 4-2A-523(1)). Note that the reference to this Article (§ 4-2A-101 et seq.) includes supplementary principles of law and equity, e.g., fraud, misrepresenta-

tion and duress. Sections 2A-103(4) and 1-103 (§§ 4-2A-103(4) and 4-1-103).

21. There is no special treatment of the finance lease in this section (§ 4-2A-523). Absent supplementary principles of law to the contrary, in most cases the supplier will have no rights or remedies against the defaulting lessee. Section 2A-209(2)(ii) (§ 4-2A-209(2)(ii)). Given that the supplier will look to the lessor for payment, this is appropriate. However, there is a specific exception to this rule with respect to the right to identify goods to the lease contract. Section 2A-524(2) (§ 4-2A-524(2)). The parties are free to create a different result in a particular case. Sections 2A-103(4) and 1-102(3) (§§ 4-2A-103(4) and 4-1-102(3)).

#### *Cross References:*

Sections 1-102(3), 1-103, 1-106(1), 1-201(37), 2-703, 2A-103(1)(j), 2A-103(4), 2A-209(2)(ii), 2A-501(4), 2A-504(1), 2A-505(1), 2A-507, 2A-510(2), 2A-524 through 2A-531, 2A-524(2), 2A-525(1), 2A-525(2), 2A-526(1), 2A-527(1), 2A-527(2), 2A-528(1) and 2A-529(3) (§§ 4-1-102(3), 4-1-103, 4-1-106(1), 4-1-201(37), 4-2-703, 4-2A-103(1)(j), 4-2A-103(4), 4-2A-209(2)(ii), 4-2A-501(4), 4-2A-504(1), 4-2A-505(1), 4-2A-507, 4-2A-510(2), 4-2A-524 — 4-2A-531, 4-2A-524(2), 4-2A-525(1), 4-2A-525(2), 4-2A-526(1), 4-2A-527(1), 4-2A-527(2), 4-2A-528(1) and 4-2A-529(3)).

#### *Definitional Cross References:*

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Installment lease contract". Section 2A-103(1)(i) (§ 4-2A-103(1)(i)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Value". Section 1-201(44) (§ 4-1-201(44)).



**Official Comment to Section 2A-524 (A.C.A. § 4-2A-524)**

*Uniform Statutory Source:* Section 2-704 (§ 4-2-704).

*Changes:* Revised to reflect leasing practices and terminology.

*Purposes:* The remedies provided by this section (§ 4-2A-524) are available to the lessor (i) if there has been a default by the lessee which falls within Section 2A-523(1) or 2A-523(3)(a), or (ii) (§ 4-2A-523(1) or 4-2A-523(3)(a), or (ii)) if there has been any other default for which the lease contract gives the lessor the remedies provided by this section (§ 4-2A-524). Under "(ii)", the lease contract may give the lessor the remedies of identification and disposition provided by this section (§ 4-2A-524) in various ways. For example, a lease provision might specifically refer to the remedies of identification and disposition, or it might refer to this section (§ 4-2A-524) by number (i.e., 2A-524 (§ 4-2A-524)), or it might do so by a more general reference such as "all rights and

remedies provided by Article 2A (§ 4-2A-101 et seq.) for default by the lessee."

*Definitional Cross References:*

"Aggrieved party". Section 1-201(2) (§ 4-1-201(2)).

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Learn". Section 1-201(25) (§ 4-1-201(25)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(i)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Supplier". Section 2A-103(1)(x) (§ 4-2A-103(1)(x)).

"Value". Section 1-201(44) (§ 4-1-201(44)).

**Official Comment to Section 2A-525 (A.C.A. § 4-2A-525)**

*Uniform Statutory Source:* Sections 2-702(1) and 9-503 (§§ 4-2-702(1) and 4-9-503).

*Changes:* Substantially revised.

*Purposes:*

1. Subsection (1) (§ 4-2A-524(1)), a revised version of the provisions of Section 2-702(1) (§ 4-2-702(1)), allows the lessor to refuse to deliver goods if the lessee is insolvent. Note that the provisions of Section 2-702(2) (§ 4-2-702(2)), granting the unpaid seller certain rights of reclamation, were not incorporated in this section (§ 4-2A-525). Subsection (2) (§ 4-2A-525(2)) made this unnecessary.

2. Subsection (2) (§ 4-2A-525(2)), a revised version of the provisions of Section 9-503 (§ 4-9-503), allows the lessor, on a Section 2A-523(1) (§ 4-2A-523(1)) or 2A-523(3)(a) (§ 4-2A-523(3)(a)) default by the lessee, the right to take possession of or reclaim the goods. Also, the lessor can contract for the right to take possession of the goods for other defaults by the lessee. Therefore, since the lessee's insolvency is an event of default in a standard lease agreement, subsection (2) (§ 4-2A-525(2))

is the functional equivalent of Section 2-702(2) (§ 4-2-702(2)). Further, subsection (2) (§ 4-2A-525(2)) sanctions the classic crate and delivery clause obligating the lessee to assemble the goods and to make them available to the lessor. Finally, the lessor may leave the goods in place, render them unusable (if they are goods employed in trade or business), and dispose of them on the lessee's premises.

3. Subsection (3) (§ 4-2A-525(3)), a revised version of the provisions of Section 9-503 (§ 4-9-503), allows the lessor to proceed under subsection (2) (§ 4-2A-525(2)) without judicial process, absent breach of the peace, or by action. Sections 2A-501(3), 2A-103(4) and 1-201(1) (§§ 4-2A-501(3), 4-2A-103(4) and 4-1-201(1)). In the appropriate case action includes injunctive relief. *Clark Equip. Co. v. Armstrong Equip. Co.*, 431 F.2d 54 (5th Cir. 1970), cert. denied, 402 U.S. 909 (1971). This Section (§ 4-2A-525), as well as a number of other Sections in this Part, are included in the Article (§ 4-2A-101 et seq.) to codify the lessor's common law right to protect the lessor's reversionary interest in the goods. Section 2A-103(1)(q) (§ 4-2A-

103(1)(q)). These Sections are intended to supplement and not displace principles of law and equity with respect to the protection of such interest. Sections 2A-103(4) and 1-103 (§§ 4-2A-103(4) and 4-1-103). Such principles apply in many instances, e.g., loss or damage to goods if risk of loss passes to the lessee, failure of the lessee to return goods to the lessor in the condition stipulated in the lease, and refusal of the lessee to return goods to the lessor after termination or cancellation of the lease. See also Section 2A-532 (§ 4-2A-532).

*Cross References:*

Sections 1-106(2), 2-702(1), 2-702(2), 2A-103(4), 2A-501(3), 2A-532 and 9-503 (§§ 4-1-106(2), 4-2-702(1), 4-2-702(2), 4-2A-103(4), 4-2A-501(3), 4-2A-532 and 4-9-503).

*Definitional Cross References:*

"Action". Section 1-201(1) (§ 4-1-201(1)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Discover". Section 1-201(25) (§ 4-1-201(25)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Insolvent". Section 1-201(23) (§ 4-1-201(23)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

**Official Comment to Section 2A-526 (A.C.A. § 4-2A-526)**

*Uniform Statutory Source:* Section 2-705 (§ 4-2-705).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

"Bill of lading". Section 1-201(6) (§ 4-1-201(6)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Discover". Section 1-201(25) (§ 4-1-201(25)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Insolvent". Section 1-201(23) (§ 4-1-201(23)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Notifies" and "Notification". Section 1-201(26) (§ 4-1-201(26)).

"Person". Section 1-201(30) (§ 4-1-201(30)).

"Receipt". Section 2-103(1)(c) (§ 4-2-103(1)(c)).

"Remedy". Section 1-201(34) (§ 4-1-201(34)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

**Official Comment to Section 2A-527 (A.C.A. § 4-2A-527)**

*Uniform Statutory Source:* Section 2-706(1), (5) and (6) (§ 4-2-706(1), (5) and (6)).

*Changes:* Substantially revised.

*Purposes:*

1. Subsection (1) (§ 4-2A-527(1)), a revised version of the first sentence of subsection 2-706(1) (§ 4-2-706(1)), allows the lessor the right to dispose of goods after a statutory or other material default by the lessee (even if the goods remain in the

lessee's possession - Section 2A-525(2)) (§ 4-2A-525(2)), after the lessor refuses to deliver or takes possession of the goods, or, if agreed, after other contractual default. The lessor's decision to exercise this right is a function of a commercial judgment, not a statutory mandate replete with sanctions for failure to comply. Cf. Section 9-507 (§ 4-9-507). As the owner of the goods, in the case of a lessor, or as the prime lessee of the goods, in the case of a sublessor, compulsory disposition of the



goods is inconsistent with the nature of the interest held by the lessor or the sublessor and is not necessary because the interest held by the lessee or the sublessee is not protected by a right of redemption under the common law or this Article (§ 4-2A-101 et seq.). Subsection 2A-527(5) (§ 4-2A-527(5)).

2. The rule for determining the measure of damages recoverable by the lessor against the lessee is a function of several variables. If the lessor has elected to effect disposition under subsection (1) (§ 4-2A-527(1)) and such disposition is by lease that qualifies under subsection (2) (§ 4-2A-527(2)), the measure of damages set forth in subsection (2) (§ 4-2A-527(2)) will apply, absent agreement to the contrary. Sections 2A-504, 2A-103(4) and 1-102(3) (§§ 4-2A-504, 4-2A-103(4) and 1-102(3)).

3. The lessor's damages will be established using the new lease agreement as a measure if the following three criteria are satisfied: (i) the lessor disposed of the goods by lease, (ii) the lease agreement is substantially similar to the original lease agreement, and (iii) such disposition was in good faith, and in a commercially reasonable manner. Thus, the lessor will be entitled to recover from the lessee the accrued and unpaid rent as of the date of commencement of the term of the new lease, and the present value, as of the same date, of the rent under the original lease for the then remaining term less the present value as of the same date of the rent under the new lease agreement applicable to the period of the new lease comparable to the remaining term under the original lease, together with incidental damages less expenses saved in consequence of the lessee's default. If the lessor's disposition does not satisfy the criteria of subsection (2) (§ 4-2A-527(2)), the lessor may calculate its claim against the lessee pursuant to Section 2A-528 (§ 4-2A-528). Section 2A-523(1)(e) (§ 4-2A-523(1)(e)).

4. Two of the three criteria to be met by the lessor are familiar, but the concept of the new lease agreement that is substantially similar to the original lease agreement is not. Given the many variables facing a party who intends to lease goods and the rapidity of change in the market place, the policy decision was made not to draft with specificity. It was thought un-

wise to seek to establish certainty at the cost of fairness. The decision of whether the new lease agreement is substantially similar to the original will be determined case by case.

5. While the section (§ 4-2A-527) does not draw a bright line, it is possible to describe some of the factors that should be considered in a finding that a new lease agreement is substantially similar to the original. The various elements of the new lease agreement should be examined. Those elements include the options to purchase or release; the lessor's representations, warranties and covenants to the lessee as well as those to be provided by the lessee to the lessor; and the services, if any, to be provided by the lessor or by the lessee. All of these factors allocate cost and risk between the lessor and the lessee and thus affect the amount of rent to be paid. These findings should not be made with scientific precision, as they are a function of economics, nor should they be made independently, as it is important that a sense of commercial judgment pervade the finding. See Section 2A-507(2) (§ 4-2A-507(2)). To establish the new lease as a proper measure of damage under subsection (2) (§ 4-2A-527(2)), these various factors, taken as a whole, must result in a finding that the new lease agreement is substantially similar to the original. If the differences between the original lease and the new lease can be easily valued, it would be appropriate for a court to find that the new lease is substantially similar to the old lease, adjust the difference in the rent between the two leases to take account of the differences, and award damages under this section (§ 4-2A-527). If, for example, the new lease requires the lessor to insure the goods in the hands of the lessee, while the original lease required the lessee to insure, the usual cost of such insurance could be deducted from rent due under the new lease before the difference in rental between the two leases is determined.

6. The following hypothetical illustrates the difficulty of providing a bright line. Assume that A buys a jumbo tractor for \$1 million and then leases the tractor to B for a term of 36 months. The tractor is delivered to and is accepted by B on May 1. On June 1 B fails to pay the monthly rent to A. B returns the tractor to A, who immediately releases the tractor to C for a

term identical to the term remaining under the lease between A and B. All terms and conditions under the lease between A and C are identical to those under the original lease between A and B, except that C does not provide any property damage or other insurance coverage, and B agreed to provide complete coverage. Coverage is expensive and difficult to obtain. It is a question of fact whether it is so difficult to adjust the recovery to take account of the difference between the two leases as to insurance that the second lease is not substantially similar to the original.

7. A new lease can be substantially similar to the original lease even though its term extends beyond the remaining term of the original lease, so long as both (a) the lease terms are commercially comparable (e.g., it is highly unlikely that a one month rental and a five-year lease would reflect similar realities), and (b) the court can fairly apportion a part of the rental payments under the new lease to that part of the term of the new lease which is comparable to the remaining lease term under the original lease. Also, the lease term of the new lease may be comparable to the remaining term of the original lease even though the beginning and ending dates of the two leases are not the same. For example, a two-month lease of agricultural equipment for the months of August and September may be comparable to a two-month lease running from the 15th of August to the 15th of October if in the particular location two-month leases beginning on August 15th are basically interchangeable with two-month leases beginning August 1st. Similarly, the term of a one-year truck lease beginning on the 15th of January may be comparable to the term of a one-year truck lease beginning January 2nd. If the lease terms are found to be comparable, the court may base cover damages on the entire difference between the costs under the two leases.

8. Subsection (3) (§ 4-2A-527(3)), which is new, provides that if the lessor's disposition is by lease that does not qualify under subsection (2) (§ 4-2A-527(2)), or is by sale or otherwise, Section 2A-528 (§ 4-2A-528) governs.

9. Subsection (4) (§ 4-2A-527(4)), a re-

vised version of subsection 2-706(5) (§ 4-2-706(5)), applies to protect a subsequent buyer or lessee who buys or leases from the lessor in good faith and for value, pursuant to a disposition under this section (§ 4-2A-527). Note that by its terms, the rule in subsection 2A-304(1) (§ 4-2A-304(1)), which provides that the subsequent lessee takes subject to the original lease contract, is controlled by the rule stated in this subsection (§ 4-2A-527(4)).

10. Subsection (5) (§ 4-2A-527(5)), a revised version of subsection 2-706(6) (§ 4-2-706(6)), provides that the lessor is not accountable to the lessee for any profit made by the lessor on a disposition. This rule follows from the fundamental premise of the bailment for hire that the lessee under a lease of goods has no equity of redemption to protect.

#### *Cross References:*

Sections 1-102(3), 2-706(1), 2-706(5), 2-706(6), 2A-103(4), 2A-304(1), 2A-504, 2A-507(2), 2A-523(1) (e), 2A-525(2), 2A-527(5), 2A-528 and 9-507 (§§ 4-1-102(3), 4-2-706(1), 4-2-706(5), 4-2-706(6), 4-2A-103(4), 4-2A-304(1), 4-2A-504, 4-2A-507(2), 4-2A-523(1)(e), 4-2A-525(2), 4-2A-527(5), 4-2A-528 and 4-9-507).

#### *Definitional Cross References:*

"Buyer" and "Buying". Section 2-103(1)(a) (§ 4-2-103(1)(a)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Good faith". Sections 1-201(19) and 2-103(1)(b) (§§ 4-1-201(19) and 4-2-103(1)(b)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Present value". Section 2A-103(1)(u) (§ 4-2A-103(1)(u)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Sale". Section 2-106(1) (§ 4-2-106(1)).

"Security interest". Section 1-201(37) (§ 4-1-201(37)).

"Value". Section 1-201(44) (§ 4-1-201(44)).



**Official Comment to Section 2A-528 (A.C.A. § 4-2A-528)\***

*Uniform Statutory Source:* Section 2-708 (§ 4-2-708).

*Changes:* Substantially revised.

*Purposes:*

1. Subsection (1) (§ 4-2A-528(1)), a substantially revised version of Section 2-708(1) (§ 4-2-708(1)), states the basic rule governing the measure of lessor's damages for a default described in Section 2A-523(1) (§ 4-2A-523(1)) or (3)(a) (§ 4-2A-523(3)(a)), and, if agreed, for a contractual default. This measure will apply if the lessor elects to retain the goods (whether undelivered, returned by the lessee, or repossessed by the lessor after acceptance and default by the lessee) or if the lessor's disposition does not qualify under subsection 2A-527(2) (§ 4-2A-527(2)). Section 2A-527(3) (§ 4-2A-527(3)). Note that under some of these conditions, the lessor may recover damages from the lessee pursuant to the rule set forth in Section 2A-529 (§ 4-2A-529). There is no sanction for disposition that does not qualify under subsection 2A-527(2) (§ 4-2A-527(2)). Application of the rule set forth in this section (§ 4-2A-528) is subject to agreement to the contrary. Sections 2A-504, 2A-103(4) and 1-102(3) (§§ 4-2A-504, 4-2A-103(4) and 4-1-102(3)).

2. If the lessee has never taken possession of the goods, the measure of damage is the accrued and unpaid rent as of the date of default together with the present value, as of the date of default, of the original rent for the remaining term of the lease less the present value as of the same date of market rent, and incidental damages, less expenses saved in consequence of the default. Note that the reference in Section 2A-528(1)(i) and (ii) (§ 4-2A-528(1)(i) and (ii)) is to the date of default not to the date of an event of default. An event of default under a lease agreement becomes a default under a lease agreement only after the expiration of any relevant period of grace and compliance with any notice requirements under this Article (§ 4-2A-101 et seq.) and the lease agreement. American Bar Foundation, *Commentaries on Indentures*, § 5-1, at 216-217 (1971). Section 2A-501(1) (§ 4-2A-501(1)). This conclusion is also a func-

tion of whether, as a matter of fact or law, the event of default has been waived, suspended or cured. Sections 2A-103(4) and 1-103 (§§ 4-2A-103(4) and 4-1-103). If the lessee has taken possession of the goods, the measure of damages is the accrued and unpaid rent as of the earlier of the time the lessor repossesses the goods or the time the lessee tenders the goods to the lessor plus the difference between the present value, as of the same time, of the rent under the lease for the remaining lease term and the present value, as of the same time, of the market rent.

3. Market rent will be computed pursuant to Section 2A-507 (§ 4-2A-501).

4. Subsection (2) (§ 4-2A-528(2)), a somewhat revised version of the provisions of subsection 2-708(2) (§ 4-2-708(2)), states a measure of damages which applies if the measure of damages in subsection (1) (§ 4-2A-528(1)) is inadequate to put the lessor in as good a position as performance would have. The measure of damage is the lessor's profit, including overhead, together with incidental damages, with allowance for costs reasonably incurred and credit for payments or proceeds of disposition. In determining the amount of due credit with respect to proceeds of disposition a proper value should be attributed to the lessor's residual interest in the goods. Sections 2A-103(1)(q) and 2A-507(4) (§§ 4-2A-103(1)(q) and 4-2A-507(4)).

5. In calculating profit, a court should include any expected appreciation of the goods, e.g. the foal of a leased brood mare. Because this subsection (§ 4-2A-528(2)) is intended to give the lessor the benefit of the bargain, a court should consider any reasonable benefit or profit expected by the lessor from the performance of the lease agreement. See *Honeywell, Inc. v. Lithonia Lighting, Inc.*, 317 F. Supp. 406, 413 (N.D. Ga. 1970); *Locks v. Wade*, 36 N.J. Super. 128, 131, 114 A.2d 875, 877 (Super. Ct. App. Div. 1955). Further, in calculating profit the concept of present value must be given effect. *Taylor v. Commercial Credit Equip. Corp.*, 170 Ga. App. 322, 316 S.E.2d 788 (Ct. App. 1984). See generally Section 2A-103(1)(u) (§ 4-2A-103(1)(u)).

*Cross References:*

Sections 1-102(3), 2-708, 2A-103(1)(u), 2A-402, 2A-504, 2A-507, 2A-527(2) and 2A-529 (§§ 4-1-102(3), 4-2-708, 4-2A-103(1)(u), 4-2A-402, 4-2A-504, 4-2A-507, 4-2A-527(2) and 4-2A-529).

*Definitional Cross References:*

"Agreement". Section 1-201(3) (§ 4-1-201(3)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Present value". Section 2A-103(1)(u) (§ 4-2A-103(1)(u)).

"Sale". Section 2-106(1) (§ 4-2-106(1)).

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\*The version of this section enacted by Arkansas differs from the uniform act.

### Official Comment to Section 2A-529 (A.C.A. § 4-2A-529)

*Uniform Statutory Source:* Section 2-709 (§ 4-2-709).

*Changes:* Substantially revised.

*Purposes:*

1. Absent a lease contract provision to the contrary, an action for the full unpaid rent (discounted to present value as of the time of entry of judgment as to rent due after that time) is available as to goods not lost or damaged only if the lessee retains possession of the goods or the lessor is or apparently will be unable to dispose of them at a reasonable price after reasonable effort. There is no general right in a lessor to recover the full rent from the lessee upon holding the goods for the lessee. If the lessee tenders goods back to the lessor, and the lessor refuses to accept the tender, the lessor will be limited to the damages it would have suffered had it taken back the goods. The rule in Article 2 (§ 4-2-101 et seq.) that the seller can recover the price of accepted goods is rejected here. In a lease, the lessor always has a residual interest in the goods which the lessor usually realizes upon at the end of a lease term by either sale or a new lease. Therefore, it is not a substantial imposition on the lessor to require it to take back and dispose of the goods if the lessee chooses to tender them back before the end of the lease term: the lessor will merely do earlier what it would have done anyway, sell or relet the goods. Further, the lessee will frequently encounter substantial difficulties if the lessee attempts to sublet the goods for the remainder of the lease term. In contrast to the buyer who owns the entire interest in goods and

can easily dispose of them, the lessee is selling only the right to use the goods under the terms of the lease and the sublessee must assume a relationship with the lessor. In that situation, it is usually more efficient to eliminate the original lessee as a middleman by allowing the lessee to return the goods to the lessor who can then redispense of them.

2. In some situations even where possession of the goods is reacquired, a lessor will be able to recover as damages the present value of the full rent due, not under this section (§ 4-2A-529), but under 2A-528(2) (§ 4-2A-528(2)) which allows a lost profit recovery if necessary to put the lessor in the position it would have been in had the lessee performed. Following is an example of such a case. A is a lessor of construction equipment and maintains a substantial inventory. B leases from A a backhoe for a period of two weeks at a rental of \$1,000. After three days, B returns the backhoe and refuses to pay the rent. A has five backhoes in inventory, including the one returned by B. During the next 11 days after the return by B of the backhoe, A rents no more than three backhoes at any one time and, therefore, always has two on hand. If B had kept the backhoe for the full rental period, A would have earned the full rental on that backhoe, plus the rental on the other backhoes it actually did rent during that period. Getting this backhoe back before the end of the lease term did not enable A to make any leases it would not otherwise have made. The only way to put A in the position it would have been in had the



lessee fully performed is to give the lessor the full rentals. A realized no savings at all because the backhoe was returned early and might even have incurred additional expense if it was paying for parking space for equipment in inventory. A has no obligation to relet the backhoe for the benefit of B rather than leasing that backhoe or any other in inventory for its own benefit. Further, it is probably not reasonable to expect A to dispose of the backhoe by sale when it is returned in an effort to reduce damages suffered by B. Ordinarily, the loss of a two-week rental would not require A to reduce the size of its backhoe inventory. Whether A would similarly be entitled to full rentals as lost profit in a one-year lease of a backhoe is a question of fact: in any event the lessor, subject to mitigation of damages rules, is entitled to be put in as good a position as it would have been had the lessee fully performed the lease contract.

3. Under subsection (2) (§ 4-2A-529(2)) a lessor who is able and elects to sue for the rent due under a lease must hold goods not lost or damaged for the lessee. Subsection (3) (§ 4-2A-529(3)) creates an exception to the subsection (2) (§ 4-2A-529(2)) requirement. If the lessor disposes of those goods prior to collection of the judgment (whether as a matter of law or agreement), the lessor's recovery is governed by the measure of damages in Section 2A-527 (§ 4-2A-527) if the disposition is by lease that is substantially similar to the original lease, or otherwise by the measure of damages in Section 2A-528 (§ 4-2A-528). Section 2A-523 (§ 4-2A-523) official comment.

4. Subsection (4) (§ 4-2A-529(4)), which is new, further reinforces the requisites of Subsection (2) (§ 4-2A-529(2)). In the event the judgment for damages obtained by the lessor against the lessee pursuant to subsection (1) (§ 4-2A-529(1)) is satisfied, the lessee regains the right to use and possession of the remaining goods for the balance of the original lease term; a partial satisfaction of the judgment creates no right in the lessee to use and possession of the goods.

5. The relationship between subsections (2) and (4) (§ 4-2A-529(2) and (4)) is important to understand. Subsection (2) (§ 4-2A-529(2)) requires the lessor to hold for the lessee identified goods in the lessor's possession. Absent agreement to the

contrary, whether in the lease or otherwise, under most circumstances the requirement that the lessor hold the goods for the lessee for the term will mean that the lessor is not allowed to use them. Sections 2A-103(4) and 1-203 (§§ 4-2A-103(4) and 4-1-203). Further, the lessor's use of the goods could be viewed as a disposition of the goods that would bar the lessor from recovery under this section (§ 4-2A-529), remitting the lessor to the two preceding sections (§§ 4-2A-527 and 4-2A-528) for a determination of the lessor's claim for damages against the lessee.

6. Subsection (5) (§ 4-2A-529(5)), the analogue of subsection 2-709(3) (§ 4-2-709(3)), further reinforces the thrust of subsection (3) (§ 4-2A-529(3)) by stating that a lessor who is held not entitled to rent under this section (§ 4-2A-529) has not elected a remedy; the lessor must be awarded damages under Sections 2A-527 and 2A-528 (§§ 4-2A-527 and 4-2A-528). This is a function of two significant policies of this Article (§ 4-2A-101 et seq.) that resort to a remedy is optional, unless expressly agreed to be exclusive (Section 2A-503(2)) (§ 4-2A-503(2)) and that rights and remedies provided in this Article (§ 4-2A-101 et seq.) generally are cumulative. (Section 2A-501(2) and (4)) (§ 4-2A-501(2) and (4)).

#### *Cross References:*

Sections 1-203, 2-709, 2-709(3), 2A-103(4), 2A-501(2), 2A-501(4), 2A-503(2), 2A-504, 2A-523(1)(e), 2A-525(2), 2A-527, 2A-528 and 2A-529(2) (§§ 4-1-203, 4-2-709, 4-2-709(3), 4-2A-103(4), 4-2A-501(2), 4-2A-501(4), 4-2A-503(2), 4-2A-504, 4-2A-523(1)(e), 4-2A-525(2), 4-2A-527, 4-2A-528 and 4-2A-529(2)).

#### *Definitional Cross References:*

"Action". Section 1-201(1) (§ 4-1-201(1)).

"Conforming". Section 2A-103(1)(d) (§ 4-2A-103(1)(d)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Lease agreement". Section 2A-103(1)(k) (§ 4-2A-103(1)(k)).

"Lease contract". Section 2A-103(1)(l) (§ 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Present value". Section 2A-103(1)(u) (§ 4-2A-103(1)(u)).

"Reasonable time". Section 1-204(1) and (2) (§ 4-1-204(1) and (2)).

### Official Comment to Section 2A-530 (A.C.A. § 4-2A-530)

*Uniform Statutory Source:* Section 2-710 (§ 4-2-710).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

"Aggrieved party". Section 1-201(2) (§ 4-1-201(2)).

"Delivery". Section 1-201(14) (§ 4-1-201(14)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

### Official Comment to Section 2A-531 (A.C.A. § 4-2A-531)

*Uniform Statutory Source:* Section 2-722 (§ 4-2-722).

*Changes:* Revised to reflect leasing practices and terminology.

*Definitional Cross References:*

"Action". Section 1-201(1) (§ 4-1-201(1)).

"Goods". Section 2A-103(1)(h) (§ 4-2A-103(1)(h)).

"Lease contract". Section 2A-103(1)(l) § 4-2A-103(1)(l)).

"Lessee". Section 2A-103(1)(n) (§ 4-2A-103(1)(n)).

"Lessor". Section 2A-103(1)(p) (§ 4-2A-103(1)(p)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Security interest". Section 1-201(37) (§ 4-1-201(37)).

### Official Comment to Section 2A-532 (A.C.A. § 4-2A-532)

*Uniform Statutory Source:* None.

*Purposes:* This section (§ 4-2A-532) recognizes the right of the lessor to recover under this Article (§ 4-2A-101 et seq.) (as well as under other law) from the lessee for failure to comply with the lease obli-

gations as to the condition of leased goods when returned to the lessor, for failure to return the goods at the end of the lease, or for any other default which causes loss or injury to the lessor's residual interest in the goods.



## ARTICLE 3

(A.C.A. § 4-3-101 ET SEQ.)\*

### Prefatory Note

Revised Article 3 (A.C.A. § 4-3-101 et seq.) (with miscellaneous and conforming amendments to Articles 1 and 4 (A.C.A. § 4-1-101 et seq. and § 4-4-101 et seq.) is a companion undertaking to Article 4A (A.C.A. § 4-4A-101 et seq.) on funds transfers. Both efforts were undertaken for the purpose of accommodating modern technologies and practices in payment systems and with respect to negotiable instruments. Both efforts were drafted by the same committee over essentially the same period of time. The work on Article 4A (A.C.A. § 4-4A-101 et seq.) was accorded priority and completed in 1989, and revised Article 3 (A.C.A. § 4-3-101 et seq.) was completed in 1990.

Revised Article 3 (A.C.A. § 4-3-101 et seq.) may, not inappropriately, be regarded as the latest effort in the progressive codification of the common law of negotiable instruments that began with the English Bills of Exchange Act enacted by Parliament in 1882. The Uniform Negotiable Instruments Law was promulgated by the Conference in 1896, and it in turn was reorganized and modernized by original Article 3—Commercial Paper as part of the Uniform Commercial Code jointly promulgated in 1952 by the Conference and the American Law Institute. Revised Article 3 (A.C.A. § 4-3-101 et seq.) in 1990 modernizes, reorganizes and clarifies the law.

#### *Purpose of Drafting Effort*

The original Articles 3 and 4 and their predecessors were based upon a paper payment system. Literally, there has been an explosion in the volume of paper to process since Articles 3 and 4 (A.C.A. § 4-3-101 et seq. and § 4-4-101 et seq.) were first promulgated. In the early '50s, around 7 billion checks were processed annually. Correctly anticipating an increase in check volume as the result of a retail approach taken by bankers at that time, the American Bankers Association in 1954 placed a team on a research and development project to identify the most

efficient method of processing checks mechanically. The eminently successful MICR line technology was the result. Upon its implementation, checks were processed at high rates of speed. In major part as a result of this technology, a seven-fold explosion in check volume has occurred between the '50s and 1988. In 1988, the Federal Reserve estimated check volume at 48 billion written annually. In 1987, Congress enacted the Expedited Funds Availability Act, and the Federal Reserve Board implemented it in 1988 with Regulation CC. Regulation CC covers many aspects of the forward check collection process and all aspects of the return process.

Present Articles 3 and 4 (A.C.A. § 4-3-101 et seq. and § 4-4-101 et seq.), written for a paper-based system, do not adequately address the issues of responsibility and liability as they relate to modern technologies now employed and the procedures required by the current volume of checks and by the "Expedited Funds Availability Act" and Regulation CC. While agreements among parties to particular transactions have provided some relief, such stop-gap measures are no longer adequate.

In addition, practices have developed which are not easily accommodated within existing Article 3 (A.C.A. § 4-3-101 et seq.). For example, variable rate notes were unknown when Article 3 (A.C.A. § 4-3-101 et seq.) first was promulgated; they are common today. Questions about the "cash equivalency" of cashier's checks and money orders have arisen as banks have sought to raise defenses to the payment of these instruments.

The revision of Article 3 (A.C.A. § 4-3-101 et seq.) and Article 4 (A.C.A. § 4-4-101 et seq.) to update, improve and maintain the viability of it is necessary to accommodate these changing practices and modern technologies, the needs of a rapidly expanding national and international economy, the requirement for more

rapid funds availability, and the need for more clarity and certainty. Absent such an update, further Federal preemption of state law may likely occur.

### *Uniformity is Essential*

Traditionally, the legal structures for payments have been regulated by state law through the Uniform Commercial Code. In recent years, however, the Federal government has established regulations for credit and debit cards, and for the availability of funds in a way that regulates much of the check collection process.

With respect to wholesale funds transfers, on an average day two trillion dollars is transferred. Article 4A (A.C.A. § 4-4A-101 et seq.) of the UCC promulgated in 1989 provides the governing comprehensive rules. In 1990, 12 states enacted Article 4A (A.C.A. § 4-4A-101 et seq.) including California, New York and Illinois. In 1991, Article 4A (A.C.A. § 4-4A-101 et seq.) has been introduced in the legislatures of most of the other states, and it is anticipated that most, if not all, will enact Article 4A (A.C.A. § 4-4A-101 et seq.) uniformly. Within a short time, perhaps by 1992, the law of wholesale funds transfers should be uniform throughout the 50 states.

The law for payments through checks and which governs other negotiable instruments similarly should be uniform and up-to-date, either through state enactments or Federal preemption. Otherwise, checks as a viable payment system in international and national transactions will be severely hampered and the utility of other negotiable instruments impaired.

### *Process of Achieving Uniformity*

The essence of uniform law revision is to obtain a sufficient consensus and balance among the interests of the various participants so that universal and uniform adoption by the legislatures of all 50 states may be achieved. As is the practice of the Conference, announcement of the drafting undertaking for Articles 3, 4 and 4A (A.C.A. § 4-3-101 et seq., § 4-4-101 et seq., and § 4-4A-101 et seq.) was widely circulated in 1985. Anyone who so requested, received notice of all meetings and was invited to attend. Upon request, names were put on a mailing list to receive copies of drafts as they progressed. In addition, the American Bar Association

Ad Hoc Committee on Payments Systems closely followed the work of the Conference and widely circulated the drafts.

The Drafting Committee had 3 or 4 meetings each year and, by August 1990, had held 20 meetings. The drafting meetings began on Friday morning and ended on Sunday at noon. All the meetings were well attended, and the average attendance was 50 or more. The discussion of the drafts was open for comment by all those who attended. In addition, the reporters received a substantial amount of comment and suggestions by written and other communications between meetings of the drafting committee. The work product was read line for line at the annual meetings of the Conference three different years. In addition, the American Law Institute circulated the drafts two or three times to its entire membership. The ALI consultative group also held a meeting to comment and make suggestions on the draft. In addition, progress reports were published annually in *The Business Lawyer* from 1985 through 1990.

The consensus, balance and quality achieved in this lengthy deliberative process is a product not only of the fine work of the reporters and the drafting committee, but also the faithful and energetic participation of the advisors and participants in the drafting meetings. The advisors representing a variety of interests were:

Thomas C. Baxter, Jr., Federal Reserve  
Bank of New York

Roland E. Brandel, American Bar Association

Leon P. Ciferni, National Westminster  
Bank USA

William B. Davenport, American Bar  
Association, Section of Business Law,  
Ad Hoc Committee on Payment Systems

Carl Felsenfeld, Association of the Bar  
of the City of New York

Thomas J. Greco, American Bankers  
Association

Oliver I. Ireland, Board of Governors of  
Federal Reserve System

John R. H. Kimball, Federal Reserve  
Bank of Boston

John F. Lee, New York Clearing House  
Association

Norman R. Nelson, New York Clearing  
House Association



Ernest T. Patrikis, Federal Reserve  
Bank of New York

Anne B. Pope, National Corporate Cash  
Management Association

Paul S. Turner, Occidental Petroleum  
Corporation and National Corporate  
Cash Management Association

Stanley M. Walker, Exxon Company,  
U.S.A. and National Corporate Cash  
Management Association

Other participants who regularly at-  
tended drafting meetings were:

Henry N. Dyhouse, U.S. Central Credit  
Union

Robert Egan, Chemical Bank

Paul T. Even, National Gypsum Corpo-  
ration

James Foorman, First Chicago Corpora-  
tion

J. Kevin French, Exxon Company,  
U.S.A.

Richard M. Gottlieb, Manufacturers  
Hanover Trust Company

Douglas E. Harris, National Corporate  
Cash Management Association

Arthur L. Herold, National Corporate  
Cash Management Association

Shirley Holder, Atlantic Richfield Com-  
pany

Paul E. Homrighausen, Bankers Clear-  
ing House Association

Gail M. Inaba, Morgan Guaranty Trust  
Company of New York

Richard P. Kessler, Jr., Credit Union  
National Association

James W. Kopp, Shell Oil Company

Donald R. Lawrence, Citibank, N.A.

Robert M. McAllister, Chase Manhat-  
tan Bank, N.A.

Thomas E. Montgomery, California  
Bankers Association

W. Robert Moore, American Bankers  
Association

Samuel Newman, Manufacturers  
Hanover Trust Company

Nena Nodge, National Corporate Cash  
Management Association

Robert J. Pisapia, Occidental Petroleum  
Corporation

Deborah S. Prutzman, Arnold & Porter  
James S. Rogers, Professor of Law,  
Newton, Massachusetts

Robert M. Rosenblith, Manufacturers  
Hanover Trust Company

Jamileh Soufan, American General Cor-  
poration

Irma Villarreal, Aon Corporation

### *Balance Achieved*

The consensus reflected in Revised Ar-  
ticle 3 (A.C.A. § 4-3-101 et seq.) and in the  
conforming amendments to Articles 1 and  
4 (A.C.A. § 4-1-101 et seq. and § 4-4-101  
et seq.) is supported by the participants  
from the banking community, the users,  
and the Federal regulators because it re-  
flects a balance that each interest can  
reasonably embrace. Some of the benefits  
of the Revision include:

#### *A. Benefits in the Public Interest*

*Certainty* — Revised Articles 3 and 4  
(A.C.A. § 4-3-101 et seq. and § 4-4-101 et  
seq.) remove numerous uncertainties that  
exist in the current provisions and thus  
reduce risk to the payment system and  
allow appropriate planning by its users  
and operators.

*Speed and Reliability* — The Revision  
removes impediments to the use of auto-  
mation, and better conforms to Regulation  
CC to expedite the availability of funds to  
customers and to reduce risks to banks.

*Lower Costs* — The Revision by provid-  
ing for modern technologies, lowers costs  
to banks and thus to their customers.

*Reduced Litigation* — By clarification of  
troublesome issues, and by the provisions  
of Sections 3-404 through 3-406 (A.C.A.  
§ 4-3-404—4-3-406) which reform rules  
for allocation of loss from forgeries and  
alterations, the Revision should signifi-  
cantly reduce litigation.

#### *B. Benefits to Users*

*"Good Faith"* — The definition of good  
faith under Sections 3-103(a)(4) and  
4-104(c) (A.C.A. §§ 4-3-103(a)(4) and 4-4-  
104(c)) is expanded to include observance  
of reasonable commercial standards of fair  
dealing. This objective standard for good  
faith applies to the performance of all  
duties and obligations established under  
Articles 3 and 4 (A.C.A. § 4-3-101 et seq.  
and § 4-4-101 et seq.).

*Fiduciary Provisions* — Section 3-307  
(A.C.A. § 4-3-307) protects drawers and  
persons owed a fiduciary responsibility by  
imposing stricter standards for obtaining  
holder in due course rights by a person  
dealing with the defaulting agent or fidu-

ciary. It also spells out the circumstances under which a person receiving funds has notice of a breach of fiduciary duty, and resulting liability.

*Accord and Satisfaction* — Under Section 3-311 (A.C.A. § 4-3-311) payees can avoid the unintentional accord and satisfaction by returning the funds or by giving a notice that requires checks to be sent to a particular office where such proposals can be handled. On the other hand, the drawer of a full settlement check is protected from the instrument being indorsed with protest and thus losing the money and being liable on the balance of the claim.

*Cashier's Checks* — Section 3-411 (A.C.A. § 4-3-411) and related provisions considerably improve the acceptability of bank obligations like cashier's checks as cash equivalents by providing disincentives to wrongful dishonor, such as the possible recovery of consequential damages.

*Indorser Liability* — Section 3-415 (A.C.A. § 4-3-415) gives more time to hold a check before the user loses indorser liability.

*Reporting Forgeries* — Section 4-406 (A.C.A. § 4-4-406) increases the outside time a customer has to report forged checks or alterations to thirty days. It also requires a bank truncating checks to retain the item or the capacity to furnish legible copies for seven years.

*Individual Agent and Corporate Liability* — Section 3-402 (A.C.A. § 4-3-402), as to corporate instruments signed by agents without adequate indication and representation, (except as against a holder in due course), allows a representative to show the parties did not intend individual liability. It affords full protection to the agent that signs a corporate check, even though the check does not show representative status. Also, Section 3-403(b) (A.C.A. § 4-3-403(b)) makes it clear that a signature of an organization is considered unauthorized if more than one signature is required and it is missing.

*Direct Suits* — Section 3-420 (A.C.A. § 4-3-420) allows a person whose indorsement is forged to sue the depository bank directly, rather than each drawee of the checks involved.

### *C. Benefits to the Banking Community*

*Certainty* — Section 3-104 (A.C.A. § 4-3-104) and related provisions clarify what types of contracts are within Article 3 (A.C.A. § 4-3-101 et seq.) and how they are to be treated, thus promoting certainty of legal rules and reducing litigation costs and risks. Checks that may omit "words of negotiability" are included as fully negotiable; confusion over travelers checks is eliminated; variable rate instruments are included; and there is clarification of the impact of the FTC "Holder" Rule, clarification of the ability of parties to an instrument that is not included in Article 3 (A.C.A. § 4-3-101 et seq.) to contract for the application of its rules to their contract; and clarification of ordinary money orders as checks rather than bank obligations.

*"Ordinary Care"* — In Sections 3-103(a)(7) and 4-104(c) (A.C.A. §§ 4-3-103(a)(7) and 4-4-104(c)), ordinary care is defined, making clear that financial institutions taking checks for processing or for payment by automated means need not manually handle each instrument if that is consistent with the institution's procedures and the procedures used do not vary unreasonably from the general usage of banks. This clarification is designed to accommodate and facilitate efficiency, thus lowering costs and lowering expedited funds availability risks. The definition of ordinary care relates to those specific instances in the Code where the standard of ordinary care is set forth.

*Statute of Limitations* — Sections 3-118 and 4-111 (A.C.A. §§ 4-3-118 and 4-4-111) include statutory periods of limitations which will make the law uniform rather than leaving the topic to widely varying state laws.

*Employee Fraud* — Section 3-405 (A.C.A. § 4-3-405) expands a per se negligence rule to the case of an indorsement forged by an employee whose duties involve handling checks. It also covers that of a faithless employee who supplies a name and then forges the indorsement, but does not require a precise match between the name of the payee and the indorsement.

*Bank Definition* — The definition of bank is expanded for the purposes of Ar-



ticles 3 and 4 (A.C.A. § 4-3-101 et seq. and § 4-4-101 et seq.) to clearly include savings and loans and credit unions so that their checks are directly governed by the Code. Section 4-104 (A.C.A. § 4-4-104) clarifies that checks drawn on credit lines are subject to the rules for checks drawn on deposit accounts.

*Truncation* — Section 4-110 (A.C.A. § 4-4-110) authorizes electronic presentment of items and related provisions remove impediments to truncation. Truncation will reduce risks from mandated funds availability and improve the check

collection process. Section 4-406 (A.C.A. § 4-4-406) allows an institution the benefit of its provisions even though it does not return the checks due to truncation. If both the customer and the institution fail to use ordinary care, a comparative negligence standard is used rather than placing the full loss on the institution.

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\*Former Article 3 was repealed by Acts 1991, No. 572, § 9 and revised Article 3 (A.C.A. § 4-3-101 et seq.) was enacted by Acts 1991, No. 572, § 5.

### Comment to § 3-102 (A.C.A. § 4-3-102)

1. Former Article 3 had no provision affirmatively stating its scope. Former Section 3-103 was a limitation on scope. In revised Article 3 (A.C.A. § 4-3-101 et seq.), Section 3-102 (A.C.A. § 4-3-102) states that Article 3 (A.C.A. § 4-3-101 et seq.) applies to “negotiable instruments,” defined in Section 3-104 (A.C.A. § 4-3-104). Section 3-104(b) (A.C.A. § 4-3-104(b)) also defines the term “instrument” as a synonym for “negotiable instrument.” In most places Article 3 (A.C.A. § 4-3-101 et seq.) uses the shorter term “instrument.” This follows the convention used in former Article 3.

2. The reference in former Section 3-103(1) to “documents of title” is omitted as superfluous because these documents contain no promise to pay money. The definition of “payment order” in Section 4A-103(a)(1)(iii) (A.C.A. § 4-4A-103(a)(1)(iii)) excludes drafts which are governed by Article 3 (A.C.A. § 4-3-101 et seq.). Section 3-102(a) (A.C.A. § 4-3-102(a)) makes clear that a payment order governed by Article 4A (A.C.A. § 4-4A-101 et seq.) is not governed by Article 3 (A.C.A. § 4-3-101 et seq.). Thus, Article 3 (A.C.A. § 4-3-101 et seq.) and Article 4A (A.C.A. § 4-4A-101 et seq.) are mutually exclusive.

Article 8 (A.C.A. § 4-8-101 et seq.) states in Section 8-102(1)(c) (A.C.A. § 4-8-102(1)(c)) that “A writing that is a certificated security is governed by this Article (Chapter) and not by Article 3 (A.C.A. § 4-3-101 et seq.), even though it also meets the requirements of that Article (Chapter).” Section 3-102(a) (A.C.A. § 4-3-102(a)) conforms to this provision. With

respect to some promises or orders to pay money, there may be a question whether the promise or order is an instrument under Section 3-104(a) (A.C.A. § 4-3-104(a)) or a certificated security under Section 8-102(a) (A.C.A. § 4-8-102(a)). Whether a writing is covered by Article 3 (A.C.A. § 4-3-101 et seq.) or Article 8 (A.C.A. § 4-8-101 et seq.) has important consequences. Among other things, under Section 8-207 (A.C.A. § 4-8-207), the issuer of a certificated security may treat the registered owner as the owner for all purposes until the presentment for registration of a transfer. The issuer of a negotiable instrument, on the other hand, may discharge its obligation to pay the instrument only by paying a person entitled to enforce under Section 3-301 (A.C.A. § 4-3-301). There are also important consequences to an indorser. An indorser of a security does not undertake the issuer’s obligation or make any warranty that the issuer will honor the underlying obligation, while an indorser of a negotiable instrument becomes secondarily liable on the underlying obligation.

Ordinarily the distinction between instruments and certificated securities in non-bearer form should be relatively clear. A certificated security under Article 8 (A.C.A. § 4-8-101 et seq.) must be in registered form (§ 8-102(1)(a)(i)) (A.C.A. § 4-8-102(1)(a)(i)) so that it can be registered on the issuer’s records. By contrast, registration plays no part in Article 3 (A.C.A. § 4-3-101 et seq.). The distinction between an instrument and a certificated security in bearer form may be somewhat more difficult and will generally lie in the

economic functions of the two writings. Ordinarily, negotiable instruments under Article 3 (A.C.A. § 4-3-101 et seq.) will be separate and distinct instruments, while certificated securities under Article 8 (A.C.A. § 4-8-101 et seq.) will be either one of a class or series (Section 8-102(1)(a)(iii)) (A.C.A. § 4-8-102(1)(a)(iii)). Thus, a promissory note in bearer form could come under either Article 3 (A.C.A. § 4-3-101 et seq.) if it were simply an individual note, or under Article 8 (A.C.A. § 4-8-101 et seq.) if it were one of a series of notes or divisible into a series. An additional distinction is whether the instrument is of the type commonly dealt in on securities exchanges or markets or commonly recognized as a medium for investment (Section 8-102(1)(a)(ii)) (A.C.A. § 4-8-102(1)(a)(ii)). Thus, a check written in bearer form (i.e., a check made payable to "cash") would not be a certificated security within Article 8 (A.C.A. § 4-8-101 et seq.) of the Uniform Commercial Code.

Occasionally, a particular writing may fit the definition of both a negotiable instrument under Article 3 (A.C.A. § 4-3-101 et seq.) and of an investment security under Article 8 (A.C.A. § 4-8-101 et seq.). In such cases, the instrument is subject exclusively to the requirements of Article 8 (A.C.A. § 4-8-101 et seq.). Section 8-102(1)(c) and Section 3-102(a) (A.C.A. §§ 4-8-102(1)(c) and 4-3-102(a)).

3. Although the terms of Article 3 (A.C.A. § 4-3-101 et seq.) apply to transactions by Federal Reserve Banks, federal preemption would make ineffective any Article 3 (A.C.A. § 4-3-101 et seq.) provision that conflicts with federal law. The activities of the Federal Reserve Banks are governed by regulations of the Federal Reserve Board and by operating circulars issued by the Reserve Banks themselves. In some instances, the operating circulars are issued pursuant to a Federal Reserve Board regulation. In other cases, the Reserve Bank issues the operating circular under its own authority under the Federal Reserve Act, subject to review by the Federal Reserve Board. Section 3-102(c) (A.C.A. § 4-3-102(c)) states that Federal Reserve Board regulations and operating

circulars of the Federal Reserve Banks supersede any inconsistent provision of Article 3 (A.C.A. § 4-3-101 et seq.) to the extent of the inconsistency. Federal Reserve Board regulations, being valid exercises of regulatory authority pursuant to a federal statute, take precedence over state law if there is an inconsistency. *Childs v. Federal Reserve Bank of Dallas*, 719 F.2d 812 (5th Cir.1983), reh. den. 724 F.2d 127 (5th Cir. 1984). Section 3-102(c) (A.C.A. § 4-3-102(c)) treats operating circulars as having the same effect whether issued under the Reserve Bank's own authority or under a Federal Reserve Board regulation. Federal statutes may also preempt Article 3 (A.C.A. § 4-3-101 et seq.). For example, the Expedited Funds Availability Act, 12 U.S.C. § 4001 et seq., provides that the Act and the regulations issued pursuant to the Act supersede any inconsistent provisions of the UCC. 12 U.S.C. § 4007(b).

4. In *Clearfield Trust Co. v. United States*, 318 U.S. (1943), the Court held that if the United States is a party to an instrument, its rights and duties are governed by federal common law in the absence of a specific federal statute or regulation. In *United States v. Kimbell Foods, Inc.*, 440 U.S. 715 (1979), the Court stated a three-pronged test to ascertain whether the federal common-law rule should follow the state rule. In most instances courts under the *Kimbell* test have shown a willingness to adopt UCC rules in formulating federal common law on the subject. In *Kimbell* the Court adopted the priorities rules of Article 9 (A.C.A. § 4-9-101 et seq.).

5. In 1989 the United Nations Commission on International Trade Law completed a Convention on International Bills of Exchange and International Promissory Notes. If the United States becomes a party to this Convention, the Convention will preempt state law with respect to international bills and notes governed by the Convention. Thus, an international bill of exchange or promissory note that meets the definition of instrument in Section 3-104 (A.C.A. § 4-3-104) will not be governed by Article 3 (A.C.A. § 4-3-101 et seq.) if it is governed by the Convention.



**Comment to § 3-103 (A.C.A. § 4-3-103)**

1. Subsection (a) (A.C.A. § 4-3-103(a)) defines some common terms used throughout the Article (Chapter) that were not defined by former Article 3 and adds the definitions of "order" and "promise" found in former Section 3-102(1)(b) and (c).

2. The definition of "order" includes an instruction given by the signer to itself. The most common example of this kind of order is a cashier's check: a draft with respect to which the drawer and drawee are the same bank or branches of the same bank. Former Section 3-118(a) treated a cashier's check as a note. It stated "a draft drawn on the drawer is effective as a note." Although it is technically more correct to treat a cashier's check as a promise by the issuing bank to pay rather than an order to pay, a cashier's check is in the form of a check and it is normally referred to as a check. Thus, revised Article 3 (A.C.A. § 4-3-101 et seq.) follows banking practice in referring to a cashier's check as both a draft and a check rather than a note. Some insurance companies also follow the practice of issuing drafts in which the drawer draws on itself and makes the draft payable at or through a bank. These instruments are also treated as drafts. The obligation of the drawer of a cashier's check or other draft drawn on the drawer is stated in Section 3-412 (A.C.A. § 4-3-412).

An order may be addressed to more than one person as drawee either jointly or in the alternative. The authorization of alternative drawees follows former Section 3-102(1)(b) and recognizes the practice of drawers, such as corporations issuing dividend checks, who for commercial convenience name a number of drawees, usually in different parts of the country. Section 3-501(b)(1) (A.C.A. § 4-3-501(b)(1)) provides that presentment may be made to any one of multiple drawees. Drawees in succession are not permitted because the holder should not be required to make more than one presentment. Dishonor by any drawee named in the draft entitles the holder to rights of recourse against the drawer or indorsers.

3. The last sentence of subsection (a)(9) (A.C.A. § 4-3-103(a)(9)) is intended to make it clear that an I.O.U. or other

written acknowledgment of indebtedness is not a note unless there is also an undertaking to pay the obligation.

4. Subsection (a)(4) (A.C.A. § 4-3-103(a)(4)) introduces a definition of good faith to apply to Articles 3 and 4 (A.C.A. § 4-3-101 et seq. and § 4-4-101 et seq.). Former Articles 3 and 4 used the definition in Section 1-201(19) (A.C.A. § 4-1-201(19)). The definition in subsection (a)(4) (A.C.A. § 4-3-103(a)(4)) is consistent with the definitions of good faith applicable to Articles 2 (A.C.A. § 4-2-101 et seq.), 2A, 4 (A.C.A. § 4-4-101 et seq.) and 4A (A.C.A. § 4-4A-101 et seq.). The definition requires not only honesty in fact but also "observance of reasonable commercial standards of fair dealing." Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely different concept than failure to deal fairly in conducting the transaction. Both fair dealing and ordinary care, which is defined in Section 3-103(a)(7) (A.C.A. § 4-3-103(a)(7)), are to be judged in the light of reasonable commercial standards, but those standards in each case are directed to different aspects of commercial conduct.

5. Subsection (a)(7) (A.C.A. § 4-3-103(a)(7)) is a definition of ordinary care which is applicable not only to Article 3 (A.C.A. § 4-3-101 et seq.) but to Article 4 (A.C.A. § 4-4-101 et seq.) as well. See Section 4-104(c) (A.C.A. § 4-4-104(c)). The general rule is stated in the first sentence of subsection (a)(7) (A.C.A. § 4-3-103(a)(7)) and it applies both to banks and to persons engaged in businesses other than banking. Ordinary care means observance of reasonable commercial standards of the relevant business prevailing in the area in which the person is located. The second sentence of subsection (a)(7) (A.C.A. § 4-3-103(a)(7)) is a particular rule limited to the duty of a bank to examine an instrument taken by a bank for processing for collection or payment by automated means. This particular rule applies primarily to Section 4-406 (A.C.A. § 4-4-406) and it is discussed in Comment

4 to that section. Nothing in Section 3-103(a)(7) (A.C.A. § 4-3-103(a)(7)) is intended to prevent a customer from proving that the procedures followed by a bank are unreasonable, arbitrary, or unfair.

6. In subsection (c) (A.C.A. § 4-3-103(c)) reference is made to a new definition of "bank" in amended Article 4 (A.C.A. § 4-4-101 et seq.).

### Comment to § 3-104 (A.C.A. § 4-3-104)

1. The definition of "negotiable instrument" defines the scope of Article 3 (A.C.A. § 4-3-101 et seq.) since Section 3-102 (A.C.A. § 4-3-102) states: "This Article (Chapter) applies to negotiable instruments." The definition in Section 3-104(a) (A.C.A. § 4-3-104(a)) incorporates other definitions in Article 3 (A.C.A. § 4-3-101 et seq.). An instrument is either a "promise," defined in Section 3-103(a)(9) (A.C.A. § 4-3-103(a)(9)), or "order," defined in Section 3-103(a)(6) (A.C.A. § 4-3-103(a)(6)). A promise is a written undertaking to pay money signed by the person undertaking to pay. An order is a written instruction to pay money signed by the person giving the instruction. Thus, the term "negotiable instrument" is limited to a signed writing that orders or promises payment of money. "Money" is defined in Section 1-201(24) (A.C.A. § 4-1-201(24)) and is not limited to United States dollars. It also includes a medium of exchange established by a foreign government or monetary units of account established by an intergovernmental organization or by agreement between two or more nations. Five other requirements are stated in Section 3-104(a) (A.C.A. § 4-3-104(a)): First, the promise or order must be "unconditional." The quoted term is explained in Section 3-106 (A.C.A. § 4-3-106). Second, the amount of money must be "a fixed amount...with or without interest or other charges described in the promise or order." Section 3-112(b) (A.C.A. § 4-3-112(b)) relates to "interest." Third, the promise or order must be "payable to bearer or to order." The quoted phrase is explained in Section 3-109 (A.C.A. § 4-3-109). An exception to this requirement is stated in subsection (c) (A.C.A. § 4-3-104(c)). Fourth, the promise or order must be payable "on demand or at a definite time." The quoted phrase is explained in Section 3-108 (A.C.A. § 4-3-108). Fifth, the promise or order may not state "any other undertaking or instruction by the person promising or ordering payment to do any

act in addition to the payment of money" with three exceptions. The quoted phrase is based on the first sentence of N.I.L. Section 5 which is the precursor of "no other promise, order, obligation or power given by the maker or drawer" appearing in former Section 3-104(1)(b). The words "instruction" and "undertaking" are used instead of "order" and "promise" that are used in the N.I.L. formulation because the latter words are defined terms that include only orders or promises to pay money. The three exceptions stated in Section 3-104(a)(3) (A.C.A. § 4-3-104(a)(3)) are based on and are intended to have the same meaning as former Section 3-112(1)(b), (c), (d), and (e), as well as N.I.L. § 5(1), (2), and (3). Subsection (b) (A.C.A. § 4-3-104(b)) states that "instrument" means a "negotiable instrument." This follows former Section 3-102(1)(e) which treated the two terms as synonymous.

2. Unless subsection (c) (A.C.A. § 4-3-104(c)) applies, the effect of subsection (a)(1) and Section 3-102(a) (A.C.A. §§ 4-3-104(a)(1) and 4-3-102(a)) is to exclude from Article 3 (A.C.A. § 4-3-101 et seq.) any promise or order that is not payable to bearer or to order. There is no provision in revised Article 3 (A.C.A. § 4-3-101 et seq.) that is comparable to former Section 3-805. The comment to former Section 3-805 states that the typical example of writing covered by that section is a check reading "Pay John Doe." Such a check was governed by former Article 3 but there could not be a holder in due course of the check. Under Section 3-104(c) (A.C.A. § 4-3-104(c)) such a check is governed by revised Article 3 (A.C.A. § 4-3-101 et seq.) and there can be a holder in due course of the check. But subsection (c) (A.C.A. § 4-3-104(c)) applies only to checks. The comment to former Section 3-805 does not state any example other than the check to illustrate that section. Subsection (c) (A.C.A. § 4-3-104(c)) is based on the belief that it is good policy to treat checks, which



are payment instruments, as negotiable instruments whether or not they contain the words "to the order of". These words are almost always pre-printed on the check form. Occasionally the drawer of a check may strike out these words before issuing the check. In the past some credit unions used check forms that did not contain the quoted words. Such check forms may still be in use but they are no longer common. Absence of the quoted words can easily be overlooked and should not affect the rights of holders who may pay money or give credit for a check without being aware that it is not in the conventional form.

Total exclusion from Article 3 (A.C.A. § 4-3-101 et seq.) of other promises or orders that are not payable to bearer or to order serves a useful purpose. It provides a simple device to clearly exclude a writing that does not fit the pattern of typical negotiable instruments and which is not intended to be a negotiable instrument. If a writing could be an instrument despite the absence of "to order" or "to bearer" language and a dispute arises with respect to the writing, it might be argued that the writing is a negotiable instrument because the other requirements of subsection (a) (A.C.A. § 4-3-104(a)) are somehow met. Even if the argument is eventually found to be without merit it can be used as a litigation ploy. Words making a promise or order payable to bearer or to order are the most distinguishing feature of a negotiable instrument and such words are frequently referred to as "words of negotiability." Article 3 (A.C.A. § 4-3-101 et seq.) is not meant to apply to contracts for the sale of goods or services or the sale or lease of real property or similar writings that may contain a promise to pay money. The use of words of negotiability in such contracts would be an aberration. Absence of the words precludes any argument that such contracts might be negotiable instruments.

An order or promise that is excluded from Article 3 (A.C.A. § 4-3-101 et seq.) because of the requirements of Section 3-104(a) (A.C.A. § 4-3-104(a)) may nevertheless be similar to a negotiable instrument in many respects. Although such a writing cannot be made a negotiable instrument within Article 3 (A.C.A. § 4-3-101 et seq.) by contract or conduct of its

parties, nothing in Section 3-104 (A.C.A. § 4-3-104) or in Section 3-102 (A.C.A. § 4-3-102) is intended to mean that in a particular case involving such a writing a court could not arrive at a result similar to the result that would follow if the writing were a negotiable instrument. For example, a court might find that the obligor with respect to a promise that does not fall within Section 3-104(a) (A.C.A. § 4-3-104(a)) is precluded from asserting a defense against a bona fide purchaser. The preclusion could be based on estoppel or ordinary principles of contract. It does not depend upon the law of negotiable instruments. An example is stated in the paragraph following Case # 2 in Comment 4 to Section 3-302 (A.C.A. § 4-3-302).

Moreover, consistent with the principle stated in Section 1-102(2)(b) (A.C.A. § 4-1-102(2)(b)), the immediate parties to an order or promise that is not an instrument may provide by agreement that one or more of the provisions of Article 3 (A.C.A. § 4-3-101 et seq.) determine their rights and obligations under the writing. Upholding the parties' choice is not inconsistent with Article 3 (A.C.A. § 4-3-101 et seq.). Such an agreement may bind a transferee of the writing if the transferee has notice of it or the agreement arises from usage of trade and the agreement does not violate law or public policy. An example of such an agreement is a provision that a transferee of the writing has the rights of a holder in due course stated in Article 3 (A.C.A. § 4-3-101 et seq.) if the transferee took rights under the writing in good faith, for value, and without notice of a claim or defense.

Even without an agreement of the parties to an order or promise that is not an instrument, it may be appropriate, consistent with the principles stated in Section 1-102(2) (A.C.A. § 4-1-102(2)), for a court to apply one or more provisions of Article 3 (A.C.A. § 4-3-101 et seq.) to the writing by analogy, taking into account the expectations of the parties and the differences between the writing and an instrument governed by Article 3 (A.C.A. § 4-3-101 et seq.). Whether such application is appropriate depends upon the facts of each case.

3. Subsection (d) (A.C.A. § 4-3-104(d)) allows exclusion from Article 3 (A.C.A. § 4-3-101 et seq.) of a writing that would otherwise be an instrument under subsection (a) (A.C.A. § 4-3-104(a)) by a state-

ment to the effect that the writing is not negotiable or is not governed by Article 3 (A.C.A. § 4-3-101 et seq.). For example, a promissory note can be stamped with the legend NOT NEGOTIABLE. The effect under subsection (d) (A.C.A. § 4-3-104(d)) is not only to negate the possibility of a holder in due course, but to prevent the writing from being a negotiable instrument for any purpose. Subsection (d) (A.C.A. § 4-3-104(d)) does not, however, apply to a check. If a writing is excluded from Article 3 (A.C.A. § 4-3-101 et seq.) by subsection (d) (A.C.A. § 4-3-104(d)), a court could, nevertheless, apply Article 3 (A.C.A. § 4-3-101 et seq.) principles to it by analogy as stated in Comment 2.

4. Instruments are divided into two general categories: drafts and notes. A draft is an instrument that is an order. A note is an instrument that is a promise. Section 3-104(e) (A.C.A. § 4-3-104(e)). The term "bill of exchange" is not used in Article 3 (A.C.A. § 4-3-101 et seq.). It is generally understood to be a synonym for the term "draft." Subsections (f) through (j) (A.C.A. § 4-3-104(f)—(j)) define particular instruments that fall within the categories of draft and note. The term "draft," defined in subsection (e) (A.C.A. § 4-3-104(e)), includes a "check" which is defined in subsection (f) (A.C.A. § 4-3-104(f)). "Check" includes a share draft drawn on a credit union payable through a bank because the definition of bank (Section 4-105) (A.C.A. § 4-4-105) includes credit unions. However, a draft drawn on an insurance payable through a bank is not a check because it is not drawn on a bank. "Money orders" are sold both by banks and non-banks. They vary in form and their form determines how they are treated in Article 3 (A.C.A. § 4-3-101 et seq.). The most common form of money order sold by banks is that of an ordinary check drawn by the purchaser except that the amount is machine impressed. That

kind of money order is a check under Article 3 (A.C.A. § 4-3-101 et seq.) and is subject to a stop order by the purchaser-drawer as in the case of ordinary checks. The seller bank is the drawee and has no obligation to a holder to pay the money order. If a money order falls within the definition of a teller's check, the rules applicable to teller's checks apply. Postal money orders are subject to federal law. "Teller's check" is separately defined in subsection (h) (A.C.A. § 4-3-104(h)). A teller's check is always drawn by a bank and is usually drawn on another bank. In some cases a teller's check is drawn on a nonbank but is made payable at or through a bank. Article 3 (A.C.A. § 4-3-101 et seq.) treats both types of teller's check identically, and both are included in the definition of "check." A cashier's check, defined in subsection (g) (A.C.A. § 4-3-104(g)), is also included in the definition of "check." Traveler's checks are issued both by banks and nonbanks and may be in the form of a note or draft. Subsection (i) (A.C.A. § 4-3-104(i)) states the essential characteristics of a traveler's check. The requirement that the instrument be "drawn on or payable at or through a bank" may be satisfied without words on the instrument that identify a bank as drawee or paying agent so long as the instrument bears an appropriate routing number that identifies a bank as paying agent.

The definitions in Regulation CC § 229.2 of the terms "check," "cashier's check," "teller's check," and "traveler's check" are different from the definitions of those terms in Article 3 (A.C.A. § 4-3-101 et seq.).

Certificates of deposit are treated in former Article 3 as a separate type of instrument. In revised Article 3 (A.C.A. § 4-3-101 et seq.), Section 3-104(j) (A.C.A. § 4-3-104(j)) treats them as notes.

### Comment to § 3-105 (A.C.A. § 4-3-105)

1. Under former Section 3-102(1)(a) (A.C.A. § 4-3-102(1)(a)) "issue" was defined as the first delivery to a "holder or a remitter" but the term "remitter" was neither defined nor otherwise used. In revised Article 3 (A.C.A. § 4-3-101 et seq.),

Section 3-105(a) (A.C.A. § 4-3-105(a)) defines "issue" more broadly to include the first delivery to anyone by the drawer or maker for the purpose of giving rights to anyone on the instrument. "Delivery" with respect to instruments is defined in Sec-



tion 1-201(14) (A.C.A. § 4-1-201(14)) as meaning "voluntary transfer of possession."

2. Subsection (b) (A.C.A. § 4-3-105(b)) continues the rule that nonissuance, conditional issuance or issuance for a special purpose is a defense of the maker or drawer of an instrument. Thus, the defense can be asserted against a person

other than a holder in due course. The same rule applies to nonissuance of an incomplete instrument later completed.

3. Subsection (c) (A.C.A. § 4-3-105(c)) defines "issuer" to include the signer of an unissued instrument for convenience of reference in the statute (A.C.A. § 4-3-105).

### Comment to § 3-106 (A.C.A. § 4-3-106)

1. This provision (A.C.A. § 4-3-106) replaces former Section 3-105. Its purpose is to define when a promise or order fulfills the requirement in Section 3-104(a) (A.C.A. § 4-3-104(a)) that it be an "unconditional" promise or order to pay. Under Section 3-106(a) (A.C.A. § 4-3-106(a)) a promise or order is deemed to be unconditional unless one of the two tests of the subsection make the promise or order conditional. If the promise or order states an express condition to payment, the promise or order is not an instrument. For example, a promise states, "I promise to pay \$100,000 to the order of John Doe if he conveys title to Blackacre to me." The promise is not an instrument because there is an express condition to payment. However, suppose a promise states, "In consideration of John Doe's promise to convey title to Blackacre, I promise to pay \$100,000 to the order of John Doe." That promise can be an instrument if Section 3-104 (A.C.A. § 4-3-104) is otherwise satisfied. Although the recital of the executory promise of Doe to convey Blackacre might be read as an implied condition that the promise be performed, the condition is not an express condition as required by Section 3-106(a)(i) (A.C.A. § 4-3-106(a)(i)). This result is consistent with former Section 3-105(1)(a) and (b). Former Section 3-105(1)(b) is not repeated in Section 3-106 (A.C.A. § 4-3-106) because it is not necessary. It is an example of an implied condition. Former Section 3-105(1)(d), (e), and (f) and the first clause of former Section 3-105(1)(c) are other examples of implied conditions. They are not repeated in Section 3-106 (A.C.A. § 4-3-106) because they are not necessary. The law is not changed.

Section 3-106(a)(ii) and (iii) (A.C.A. § 4-3-106(a)(ii) and (iii)) carry forward the substance of former Section 3-105(2)(a).

The only change is the use of "writing" instead of "agreement" and a broadening of the language that can result in conditionality. For example, a promissory note is not an instrument defined by Section 3-104 (A.C.A. § 4-3-104) if it contains any of the following statements: 1. "This note is subject to a contract of sale dated April 1, 1990 between the payee and maker of this note." 2. "This note is subject to a loan and security agreement dated April 1, 1990 between the payee and maker of this note." 3. "Rights and obligations of the parties with respect to this note are stated in an agreement dated April 1, 1990 between the payee and maker of this note." It is not relevant whether any condition to payment is or is not stated in the writing to which reference is made. The rationale is that the holder of a negotiable instrument should not be required to examine another document to determine rights with respect to payment. But subsection (b)(i) (A.C.A. § 4-3-106(b)(i)) permits reference to a separate writing for information with respect to collateral, prepayment, or acceleration.

Many notes issued in commercial transactions are secured by collateral, are subject to acceleration in the event of default, or are subject to prepayment, or acceleration does not prevent the note from being an instrument if the statement is in the note itself. See Section 3-104(a)(3) and Section 3-108(b) (A.C.A. § 4-3-104(a)(3) and 4-3-108(b)). In some cases it may be convenient not to include a statement concerning collateral, prepayment, or acceleration in the note, but rather to refer to an accompanying loan agreement, security agreement or mortgage for that statement. Subsection (b)(i) (A.C.A. § 4-3-106(b)(i)) allows a reference to the appropriate writing for a statement of these rights. For example, a note would not be made conditional by the following statement: "This note is secured by a

security interest in collateral described in a security agreement dated April 1, 1990 between the payee and maker of this note. Rights and obligations with respect to the collateral are [stated in] [governed by] the security agreement." The bracketed words are alternatives, either of which complies.

Subsection (b)(ii) (A.C.A. § 4-3-106(b)(ii)) addresses the issues covered by former Section 3-105(1)(f), (g), and (h) and Section 3-105(2)(b). Under Section 3-106(a) (A.C.A. § 4-3-106(a)) a promise or order is not made conditional because payment is limited to payment from a particular source or fund. This reverses the result of former Section 3-105(2)(b). There is no cogent reason why the general credit of a legal entity must be pledged to have a negotiable instrument. Market forces determine the marketability of instruments of this kind. If potential buyers don't want promises or orders that are payable only from a particular source or fund, they won't take them, but Article 3 (A.C.A. § 4-3-101 et seq.) should apply.

2. Subsection (c) (A.C.A. § 4-3-106(c)) applies to traveler's checks or other instruments that may require a countersignature. Although the requirement of a countersignature is a condition to the obligation to pay, traveler's checks are treated in the commercial world as money substitutes and therefore should be governed by Article 3 (A.C.A. § 4-3-101 et seq.). The first sentence of subsection (c) (A.C.A. § 4-3-106(c)) allows a traveler's check to meet the definition of instrument by stating that the countersignature condition does not make it conditional for the purposes of Section 3-104 (A.C.A. § 4-3-104). The second sentence states the effect of a failure to meet the condition. Suppose a thief steals a traveler's check and cashes it by skillfully imitating the specimen signature so that the countersignature appears to be authentic. The countersignature is for the purpose of identification of the owner of the instrument. It is not an indorsement. Subsection (c) (A.C.A. § 4-3-106(c)) provides that the failure of the owner to countersign does not prevent a transferee from becoming a holder. Thus, the merchant or bank that cashed the traveler's check becomes a holder when the traveler's check is taken. The forged countersignature is a defense to the obligation of the issuer to pay the instrument, and is included in defenses under Section

3-305(a)(2) (A.C.A. § 4-3-305(a)(2)). These defenses may not be asserted against a holder in due course. Whether a holder has notice of the defense is a factual question. If the countersignature is a very bad forgery, there may be notice. But if the merchant or bank cashed a traveler's check and the countersignature appeared to be similar to the specimen signature, there might not be notice that the countersignature was forged. Thus, the merchant or bank could be a holder in due course.

3. Subsection (d) (A.C.A. § 4-3-106(d)) concerns the effect of a statement to the effect that the rights of a holder or transferee are subject to claims and defenses that the issuer could assert against the original payee. The subsection applies only if the statement is required by Statutory or administrative law. The prime example is the Federal Trade Commission Rule (16 C.F.R. Part 433) preserving consumers' claims and defenses in consumer credit sales. The intent of the FTC rule is to make it impossible for there to be a holder in due course of a note bearing FTC legend and undoubtedly that is the result. But, under former Article 3, the legend may also have had the unintended effect of making the note conditional, thus excluding the note from former Article 3 altogether. Subsection (d) (A.C.A. § 4-3-106(d)) is designed to make it possible to preclude the possibility of a holder in due course without excluding the instrument from Article 3 (A.C.A. § 4-3-101 et seq.). Most of the provisions of Article 3 (A.C.A. § 4-3-101 et seq.) are not affected by the holder-in-due-course doctrine and there is no reason why Article 3 (A.C.A. § 4-3-101 et seq.) should not apply to a note bearing the FTC legend if holder-in-due-course rights are not involved. Under subsection (d) (A.C.A. § 4-3-106(d)) the statement does not make the note conditional. If the note otherwise meets the requirements of Section 3-104(a) (A.C.A. § 4-3-104(a)) it is a negotiable instrument for all purposes except that there cannot be a holder in due course of the note. No particular form of legend or statement is required by subsection (d) (A.C.A. § 4-3-106(d)). The form of a particular legend or statement may be determined by the other statute or administrative law. For example, the FTC legend required in a note taken by the seller in a consumer sale of goods or services is



tailored to that particular transaction and therefore uses language that is somewhat different from that stated in subsection (d) (A.C.A. § 4-3-106(d)), but the difference in expression does not affect the essential similarity of the message conveyed. The

effect of the FTC legend is to make the rights of a holder or transferee subject to claims or defenses that the issuer could assert against the original payee of the note.

### **Comment to § 3-107 (A.C.A. § 4-3-107)**

The definition of instrument in Section 3-104 (A.C.A. § 4-3-104) requires that the promise or order be payable in "money." That term is defined in Section 1-201(24) (A.C.A. § 4-1-201(24)) and is not limited to United States dollars. Section 3-107 (A.C.A. § 4-3-107) states that an instrument payable in foreign money may be

paid in dollars if the instrument does not prohibit it. It also states a conversion rate which applies in the absence of a different conversion rate stated in the instrument. The reference in former Section 3-107(1) to instruments payable in "currency" or "current funds" has been dropped as superfluous.

### **Comment to § 3-108 (A.C.A. § 4-3-108)**

This section (A.C.A. § 4-3-108) is a restatement of former Section 3-108 and Section 3-109. Subsection (b) (A.C.A. § 4-3-108(b)) broadens former Section 3-109 somewhat by providing that a definite time includes a time readily ascertainable at the time the promise or order is issued. Subsection (b)(iii) and (iv) (A.C.A. § 4-3-108(b)(iii) and (iv)) restates former Section 3-109(1)(d). It adopts the generally accepted rule that a clause providing for extension at the option of the holder, even without a time limit, does not affect nego-

tiability since the holder is given only a right which the holder would have without the clause. If the extension is to be at the option of the maker or acceptor or is to be automatic, a definite time limit must be stated or the time of payment remains uncertain and the order or promise is not a negotiable instrument. If a definite time limit is stated, the effect upon certainty of time of payment is the same as if the instrument were made payable at the ultimate date with a term providing for acceleration.

### **Comment to § 3-109 (A.C.A. § 4-3-109)**

1. Under Section 3-104(a) (A.C.A. § 4-3-104(a)), a promise or order cannot be an instrument unless the instrument is payable to bearer or to order when it is issued or unless Section 3-104(c) (A.C.A. § 4-3-104(c)) applies. The terms "payable to bearer" and "payable to order" are defined in Section 3-109 (A.C.A. § 4-3-109). The quoted terms are also relevant in determining how an instrument is negotiated. If the instrument is payable to bearer it can be negotiated by delivery alone. Section 3-201(b) (A.C.A. § 4-3-201(b)). An instrument that is payable to an identified person cannot be negotiated without the indorsement of the identified person. Section 3-201(b) (A.C.A. § 4-3-201(b)). An instrument payable to order is payable to an identified person. Section 3-109(b) (A.C.A. § 4-3-109(b)). Thus, an instrument payable to order requires the indorsement of

the person to whose order the instrument is payable.

2. Subsection (a) (A.C.A. § 4-3-109(a)) states when an instrument is payable to bearer. An instrument is payable to bearer if it states that it is payable to bearer, but some instruments use ambiguous terms. For example, check forms usually have the words "to the order of" printed at the beginning of the line to be filled in for the name of the payee. If the drawer writes in the word "bearer" or "cash," the check reads "to the order of bearer" or "to the order of cash." In each case the check is payable to bearer. Sometimes the drawer will write the name of the payee "John Doe" but will add the words "or bearer." In that case the check is payable to bearer. Subsection (a) (A.C.A. § 4-3-109(a)). Under subsection (b) (A.C.A. § 4-3-109(b)), if an instrument is payable to bearer it can't

be payable to order. This is different from former Section 3-110(3). An instrument that purports to be payable both to order and bearer states contradictory terms. A transferee of the instrument should be able to rely on the bearer term and acquire rights as a holder without obtaining the indorsement of the identified payee. An instrument is also payable to bearer if it does not state a payee. Instruments that do not state a payee are in most cases incomplete instruments. In some cases the drawer of a check may deliver or mail it to the person to be paid without filling in the line for the name of the payee. Under subsection (a) (A.C.A. § 4-3-109(a)) the check is payable to bearer when it is sent or delivered. It is also an incomplete instrument. This case is discussed in

Comment 2 to Section 3-115 (A.C.A. § 4-3-115). Subsection (a)(3) (A.C.A. § 4-3-109(a)(3)) contains the words "otherwise indicates that it is not payable to an identified person." The quoted words are meant to cover uncommon cases in which an instrument indicates that it is not meant to be payable to a specific person. Such an instrument is treated like a check payable to "cash." The quoted words are not meant to apply to an instrument stating that it is payable to an identified person such as "ABC Corporation" if ABC Corporation is a nonexistent company. Although the holder of the check cannot be the nonexistent company, the instrument is not payable to bearer. Negotiation of such an instrument is governed by Section 3-404(b) (A.C.A. § 4-3-404(b)).

### Comment to § 3-110 (A.C.A. § 4-3-110)

1. Section 3-110 (A.C.A. § 4-3-110) states rules for determining the identity of the person to whom an instrument is initially payable if the instrument is payable to an identified person. This issue usually arises in a dispute over the validity of an indorsement in the name of the payee. Subsection (a) (A.C.A. § 4-3-110(a)) states the general rule that the person to whom an instrument is payable is determined by the intent of "the person, whether or not authorized, signing as, or in the name or behalf of, the issuer of the instrument." "Issuer" means the maker or drawer of the instrument. Section 3-105(c) (A.C.A. § 4-3-105(c)). If X signs a check as drawer of a check on X's account, the intent of X controls. If X, as President of Corporation, signs a check as President in behalf of Corporation as drawer, the intent of X controls. If X forges Y's signature as drawer of a check, the intent of X also controls. Under Section 3-103(a)(3) (A.C.A. § 4-3-103(a)(3)), Y is referred to as the drawer of the check because the signing of Y's name identifies Y as the drawer. But since Y's signature was forged Y has no liability as drawer (Section 3-403(a)) (A.C.A. § 4-3-403(a)) unless some other provision of Article 3 (A.C.A. § 4-3-101 et seq.) or Article 4 (A.C.A. § 4-4-101 et seq.) makes Y liable. Since X, even though unauthorized, signed in the name of Y as issuer, the intent of X determines to whom the check is payable.

In the case of a check payable to "John Smith," since there are many people in the world named "John Smith" it is not possible to identify the payee of the check unless there is some further identification or the intention of the drawer is determined. Name alone is sufficient under subsection (a) (A.C.A. § 4-3-110(a)), but the intention of the drawer determines which John Smith is the person to whom the check is payable. The same issue is presented in cases of misdescriptions of the payee. The drawer intends to pay a person known to the drawer as John Smith. In fact that person's name is James Smith or John Jones or some other entirely different name. If the check identifies the payee as John Smith, it is nevertheless payable to the person intended by the drawer. That person may indorse the check in either the name John Smith or the person's correct name or in both names. Section 3-204(d) (A.C.A. § 4-3-204(d)). The intent of the drawer is also controlling in fictitious payee cases. Section 3-404(b) (A.C.A. § 4-3-404(b)). The last sentence of subsection (a) (A.C.A. § 4-3-110(a)) refers to rare cases in which the signature of an organization requires more than one signature and the persons signing on behalf of the organization do not all intend the same person as payee. Any person intended by a signer for the organization is the payee and an indorsement by that person is an effective indorsement.



Subsection (b) (A.C.A. § 4-3-110(b)) recognizes that fact that in a large number of cases there is no human signer of an instrument because the instrument, usually a check, is produced by automated means such as a check-writing machine. In that case, the relevant intent is that of the person who supplied the name of the payee. In most cases that person is an employee of the drawer, but in some cases the person could be an outsider who is committing a fraud by introducing names of payees of checks into the system that produces the checks. A check-writing machine is likely to be operated by means of a computer in which is stored information as to name and address of the payee and the amount of the check. Access to the computer may allow production of fraudulent checks without knowledge of the organization that is the issuer of the check. Section 3-404(b) (A.C.A. § 4-3-404(b)) is also concerned with this issue. See Case # 4 in Comment 2 to Section 3-404 (A.C.A. § 4-3-404).

2. Subsection (c) (A.C.A. § 4-3-110(b)) allows the payee to be identified in any way including the various ways stated. Subsection (c)(1) (A.C.A. § 4-3-110(c)(1)) relates to instruments payable to bank accounts. In some cases the account might be identified by name and number, and the name and number might refer to different persons. For example, a check is payable to "X Corporation Account No. 12345 in Bank of Podunk." Under the last sentence of subsection (c)(1) (A.C.A. § 4-3-110(c)(1)), this check is payable to X Corporation and can be negotiated by X Corporation even if Account No. 12345 is some other person's account or the check is not deposited in that account. In other cases the payee is identified by an account number and the name of the owner of the account is not stated. For example, Debtor pays Creditor by issuing a check drawn on Payor Bank. The check is payable to a bank account owned by Creditor but identified only by number. Under the first sentence of subsection (c)(1) (A.C.A. § 4-3-110(c)(1)) the check is payable to Creditor and, under Section 1-201(20) (A.C.A. § 4-1-201(20)), Creditor becomes the holder when the check is delivered. Under Section 3-201(b) (A.C.A. § 4-3-201(b)), further negotiation of the check requires the indorsement of Creditor. But under Section 4-205(a) (A.C.A. § 4-4-205(a)), if

the check is taken by a depository bank for collection, the bank may become a holder without the indorsement. Under Section 3-102(b) (A.C.A. § 4-3-102(b)), provisions of Article 4 (A.C.A. § 4-4-101 et seq.) prevail over those of Article 3 (A.C.A. § 4-3-101 et seq.). The depository bank warrants that the amount of the check was credited to the payee's account.

3. Subsection (c)(2) (A.C.A. § 4-3-110(c)(2)) replaces former Section 3-117 and subsection (1)(e), (f), and (g) of former Section 3-110. This provision merely determines who can deal with an instrument as a holder. It does not determine ownership of the instrument or its proceeds. Subsection (c)(2)(i) (A.C.A. § 4-3-110(c)(2)(i)) covers trusts and estates. If the instrument is payable to the trust or estate or the trustee or representative of the trust or estate, the instrument is payable to the trustee or representative or any successor. Under subsection (c)(2)(ii) (A.C.A. § 4-3-110(c)(2)(ii)), if the instrument states that it is payable to Doe, President of X Corporation, either Doe or X Corporation can be holder of the instrument. Subsection (c)(2)(iii) (A.C.A. § 4-3-110(c)(2)(iii)) concerns informal organizations that are not legal entities such as unincorporated clubs and the like. Any representative of the members of the organization can act as holder. Subsection (c)(2)(iv) (A.C.A. § 4-3-110(c)(2)(iv)) applies principally to instruments payable to public offices such as a check payable to County Tax Collector.

4. Subsection (d) (A.C.A. § 4-3-110(d)) replaces former Section 3-116. An instrument payable to X or Y is governed by the first sentence of subsection (d) (A.C.A. § 4-3-110(d)). An instrument payable to X and Y is governed by the second sentence of subsection (d) (A.C.A. § 4-3-110(d)). If an instrument is payable to X or Y, either is the payee and if either is in possession that person is the holder and the person entitled to enforce the instrument. Section 3-301 (A.C.A. § 4-3-301). If an instrument is payable to X and Y, neither X nor Y acting alone is the person to whom the instrument is payable. Neither person, acting alone, can be the holder of the instrument. The instrument is "payable to an identified person." The "identified person" is X and Y acting jointly. Section 3-109(b) and Section 1-102(5)(a) (A.C.A. §§ 4-3-109(b) and 4-1-102(5)(a)). Thus,

under Section 1-201(20) (A.C.A. § 4-1-201(20)) X or Y, acting alone, cannot be the holder or the person entitled to enforce or negotiate the instrument because neither, acting alone, is the identified person stated in the instrument.

The third sentence of subsection (d) (A.C.A. § 4-3-110(d)) is directed to cases

in which it is not clear whether an instrument is payable to multiple payees alternatively. In the case of ambiguity persons dealing with the instrument should be able to rely on the indorsement of a single payee. For example, an instrument payable to X and/or Y is treated like an instrument payable to X or Y.

#### **Comment to § 3-111 (A.C.A. § 4-3-111)**

If an instrument is payable at a bank in the United States, Section 3-501(b)(1) (A.C.A. § 4-3-501(b)(1)) states that presentment must be made at the place of

payment, i.e. the bank. The place of presentment of a check is governed by Regulation CC § 229.36.

#### **Comment to § 3-112 (A.C.A. § 4-3-112)**

1. Under Section 3-104(a) (A.C.A. § 4-3-104(a)) the requirement of a "fixed amount" applies only to principal. The amount of interest payable is that described in the instrument. If the description of interest in the instrument does not allow for the amount of interest to be ascertained, interest is payable at the judgment rate. Hence, if an instrument calls for interest, the amount of interest will always be determinable. If a variable rate of interest is prescribed, the amount of interest is ascertainable by reference to

the formula or index described or referred to in the instrument. The last sentence of subsection (b) (A.C.A. § 4-3-112(b)) replaces subsection (d) of former Section 3-118.

2. The purpose of subsection (b) (A.C.A. § 4-3-112(b)) is to clarify the meaning of "interest" in the introductory clause of Section 3-104(a) (A.C.A. § 4-3-104(a)). It is not intended to validate a provision for interest in an instrument if that provision violates other law.

#### **Comment to § 3-113 (A.C.A. § 4-3-113)**

This section (A.C.A. § 4-3-113) replaces former Section 3-114. Subsections (1) and (3) of former Section 3-114 are deleted as unnecessary. Section 3-113(a) (A.C.A. § 4-3-113(a)) is based in part on subsection (2) of former Section 3-114. The rule that a demand instrument is not payable before the date of the instrument is subject to

Section 4-401(c) (A.C.A. § 4-4-401(c)) which allows the payor or bank to pay a postdated check unless the drawer has notified the bank of the postdating pursuant to a procedure prescribed in that subsection. With respect to an updated instrument, the date is the date of issue.

#### **Comment to § 3-114 (A.C.A. § 4-3-114)**

Section 3-114 (A.C.A. § 4-3-114) replaces subsections (b) and (c) of former Section 3-118.

#### **Comment to § 3-115 (A.C.A. § 4-3-115)**

1. This section (A.C.A. § 4-3-115) generally carries forward the rules set forth in former Section 3-115. The term "incomplete instrument" applies both to an "instrument," i.e. a writing meeting all the

requirements of Section 3-104 (A.C.A. § 4-3-104), and to a writing intended to be an instrument that is signed but lacks some element of an instrument. The test in both cases is whether the contents show



that it is incomplete and that the signer intended that additional words or numbers be added.

2. If an incomplete instrument meets the requirements of Section 3-104 (A.C.A. § 4-3-104) and is not completed it may be enforced in accordance with its terms. Suppose, in the following two cases, that a note delivered to the payee is incomplete solely because a space on the pre-printed note form for the due date is not filled in:

*Case # 1.* If the incomplete instrument is never completed, the note is payable on demand. Section 3-108(a)(ii) (A.C.A. § 4-3-108(a)(ii)). However, if the payee and the maker agreed to a due date, the maker may have a defense under Section 3-117 (A.C.A. § 4-3-117) if demand for payment is made before the due date agreed to by the parties.

*Case # 2.* If the payee completes the note by filling in the due date agreed to by the parties, the note is payable on the due date stated. However, if the due date filled in was not the date agreed to by the parties there is an alteration of the note. Section 3-407 (A.C.A. § 4-3-407) governs the case.

Suppose Debtor pays Creditor by giving Creditor a check on which the space for

the name of the payee is left blank. The check is an instrument but it is incomplete. The check is enforceable in its incomplete form and it is payable to bearer because it does not state a payee. Section 3-109(a)(2) (A.C.A. § 4-3-109(a)(2)). Thus, Creditor is a holder of the check. Normally in this kind of case Creditor would simply fill in the space with Creditor's name. When that occurs the check becomes payable to the Creditor.

3. In some cases the incomplete instrument does not meet the requirements of Section 3-104 (A.C.A. § 4-3-104). An example is a check with the amount not filled in. The check cannot be enforced until the amount is filled in. If the payee fills in an amount authorized by the drawer the check meets the requirements of Section 3-104 (A.C.A. § 4-3-104) and is enforceable as completed. If the payee fills in an unauthorized amount there is an alteration of the check and Section 3-407 (A.C.A. § 4-3-407) applies.

4. Section 3-302(a)(1) (A.C.A. § 4-3-302(a)(1)) also bears on the problem of incomplete instruments. Under that section a person cannot be a holder in due course of the instrument if it is so incomplete as to call into question its validity. Subsection (d) of Section 3-115 (A.C.A. § 4-3-115(d)) is based on the last clause of subsection (2) of former Section 3-115.

### Comment to § 3-116 (A.C.A. § 4-3-116)

1. Subsection (a) (A.C.A. § 4-3-116(a)) replaces subsection (e) of former Section 3-118. Subsection (b) (A.C.A. § 4-3-116(b)) states contribution rights of parties with joint and several liability by referring to applicable law. But subsection (b) (A.C.A. § 4-3-116(b)) is subject to Section 3-419(e) (A.C.A. § 4-3-419(e)). If one of the parties with joint and several liability is an accommodation party and the other is the accommodated party, Section 3-419(e) (A.C.A. § 4-3-419(e)) applies. Subsection (c) (A.C.A. § 4-3-116(c)) deals with discharge. The discharge of a jointly and severally liable obligor does not affect the right of other obligors to seek contribution from the discharged obligor.

2. Indorsers normally do not have joint and several liability. Rather, an earlier

indorser has liability to a later indorser. But indorsers can have joint and several liability in two cases. If an instrument is payable to two payees jointly, both payees must indorse. The indorsement is a joint indorsement and indorsers have joint and several liability and subsection (b) (A.C.A. § 4-3-116(b)) applies. The other case is that of two or more anomalous indorsers. The term is defined in Section 3-205(d) (A.C.A. § 4-3-205(d)). An anomalous indorsement normally indicates that the indorser signed as an accommodation party. If more than one accommodation party indorses a note as an accommodation to the maker, the indorsers have joint and several liability and subsection (b) (A.C.A. § 4-3-116(b)) applies.

**Comment to § 3-117 (A.C.A. § 4-3-117)**

1. The separate agreement might be a security agreement or mortgage or it might be an agreement that contradicts the terms of the instrument. For example, a person may be induced to sign an instrument under an agreement that the signer will not be liable on the instrument unless certain conditions are met. Suppose X requested credit from Creditor who is willing to give the credit only if an acceptable accommodation party will sign the note of X as co-maker. Y agrees to sign as co-maker on the condition that Creditor also obtain the signature of Z as co-maker. Creditor agrees and Y signs as co-maker with X. Creditor fails to obtain the signature of Z on the note. Under Sections 3-412 and 3-419(b) (A.C.A. §§ 4-3-412 and 4-3-419(b)), Y is obliged to pay the note, but Section 3-117 (A.C.A. § 4-3-117) applies. In this case, the agreement modifies the terms of the note by stating a condition to the obligation of Y to pay the note. This case is essentially similar to a case in which a maker of a note is induced to sign the note by fraud of the holder. Although the agreement that Y not be liable on the note unless Z also signs may not have been fraudulently made, a subsequent attempt by Creditor to require Y to pay the note in violation of the agreement is a bad faith act. Section 3-117 (A.C.A. § 4-3-117),

in treating the agreement as a defense, allows Y to assert the agreement against Creditor, but the defense would not be good against a subsequent holder in due course of the note that took it without notice of the agreement. If there cannot be a holder in due course because of Section 3-106(d) (A.C.A. § 4-3-106(d)), a subsequent holder that took the note in good faith, for value and without knowledge of the agreement would not be able to enforce the liability of Y. This result is consistent with the risk that a holder not in due course takes with respect to fraud in inducing issuance of an instrument.

2. The effect of merger or integration clauses to the effect that a writing is intended to be the complete and exclusive statement of the terms of the agreement or that the agreement is not subject to conditions is left to the supplementary law of the jurisdiction pursuant to Section 1-103 (A.C.A. § 4-1-103). Thus, in the case discussed in Comment 1, whether Y is permitted to prove the condition to Y's obligation to pay the note is determined by that law. Moreover, nothing in this section is intended to validate an agreement which is fraudulent or void as against public policy, as in the case of a note given to deceive a bank examiner.

**Comment to § 3-118 (A.C.A. § 4-3-118)**

1. Section 3-118 (A.C.A. § 4-3-118) differs from former Section 3-122, which states when a cause of action accrues on an instrument. Section 3-118 (A.C.A. § 4-3-118) does not define when a cause of action accrues. Accrual of a cause of action is stated in other sections of Article 3 (A.C.A. § 4-3-101 et seq.) such as those that state the various obligations of parties to an instrument. The only purpose of Section 3-118 (A.C.A. § 4-3-118) is to define the time within which an action to enforce an obligation, duty, or right arising under Article 3 (A.C.A. § 4-3-101 et seq.) must be commenced. Section 3-118 (A.C.A. § 4-3-118) does not attempt to state all rules with respect to a statute of limitations. For example, the circumstances under which the running of a limitations period may be tolled is left to

other law pursuant to Section 1-103 (A.C.A. § 4-1-103).

2. The first six subsections (A.C.A. § 4-3-118(a) — (f)) apply to actions to enforce an obligation of any party to an instrument to pay the instrument. This changes present law in that indorsers who may become liable on an instrument after issue are subject to a period of limitations running from the same date as that of the maker or drawer. Subsections (a) and (b) (A.C.A. § 4-3-118(a) and (b)) apply to notes. If the note is payable at a definite time, a six-year limitations period starts at the due date of the note, subject to prior acceleration. If the note is payable on demand, there are two limitations periods. Although a note payable on demand could theoretically be called a day after it was issued, the normal expectation of the



parties is that the note will remain outstanding until there is some reason to call it. If the law provides that the limitations period does not start until demand is made, the cause of action to enforce it may never be barred. On the other hand, if the limitations period starts when demand for payment may be made, i.e. at any time after the note was issued, the payee of a note on which interest or portions of principal are being paid could lose the right to enforce the note even though it was treated as a continuing obligation by the parties. Some demand notes are not enforced because the payee has forgiven the debt. This is particularly true in family and other noncommercial transactions. A demand note found after the death of the payee may be presented for payment many years after it was issued. The maker may be a relative and it may be difficult to determine whether the note represents a real or a forgiven debt. Subsection (b) (A.C.A. § 4-3-118(b)) is designed to bar notes that no longer represent a claim to payment and to require reasonably prompt action to enforce notes on which there is default. If a demand for payment is made to the maker, a six-year limitations period starts to run when demand is made. The second sentence of subsection (b) (A.C.A. § 4-3-118(b)) bars an action to enforce a demand note if no demand has been made on the note and no payment of interest or principal has been made for a continuous period of 10 years. This covers the case of a note that does not bear interest or a case in which interest due on the note has not been paid. This kind of case is likely to be a family transaction in which a failure to demand payment may indicate that the holder did not intend to enforce the obligation but neglected to destroy the note. A limitations period that bars stale claims in this kind of case is appropriate if the period is relatively long.

3. Subsection (c) (A.C.A. § 4-3-118(c)) applies primarily to personal uncertified checks. Checks are payment instruments rather than credit instruments. The limitations period expires three years after the date of dishonor or 10 years after the date of the check, whichever is earlier. Teller's checks, cashier's checks, certified checks, and traveler's checks are treated differently under subsection (d) (A.C.A. § 4-3-118(d)) because they are commonly treated as cash equivalents. A great delay

in presenting a cashier's check for payment in most cases will occur because the check was mislaid during that period. The person to whom traveler's checks are issued may hold them indefinitely as a safe form of cash for use in an emergency. There is no compelling reason for barring the claim of the owner of the cashier's check or traveler's check. Under subsection (d) (A.C.A. § 4-3-118(d)) the claim is never barred because the three-year limitations period does not start to run until demand for payment is made. The limitations period in subsection (d) (A.C.A. § 4-3-118(d)) in effect applies only to cases in which there is a dispute about the legitimacy of the claim of the person demanding payment.

4. Subsection (e) (A.C.A. § 4-3-118(e)) covers certificates of deposit. The limitations period of six years doesn't start to run until the depositor demands payment. Most certificates of deposit are payable on demand even if they state a due date. The effect of a demand for payment before maturity is usually that the bank will pay, but that a penalty will be assessed against the depositor in the form of a reduction in the amount of interest that is paid. Subsection (e) (A.C.A. § 4-3-118(e)) also provides for cases in which the bank has no obligation to pay until the due date. In that case the limitations period doesn't start to run until there is a demand for payment in effect and the due date has passed.

5. Subsection (f) (A.C.A. § 4-3-118(f)) applies to accepted drafts other than certified checks. When a draft is accepted it is in effect turned into a note of the acceptor. In almost all cases the acceptor will agree to pay at a definite time. Subsection (f) (A.C.A. § 4-3-118(f)) states that in that case the six-year limitations period starts to run on the due date. In the rare case in which the obligation of the acceptor is payable on demand, the six-year limitations period starts to run at the date of the acceptance.

6. Subsection (g) (A.C.A. § 4-3-118(g)) covers warranty and conversion cases and other actions to enforce obligations or rights arising under Article 3 (A.C.A. § 4-3-101 et seq.). A three-year period is stated and subsection (g) (A.C.A. § 4-3-118(g)) follows general law in stating that the period runs from the time the cause of action accrues. Since the traditional term

"cause of action" may have been replaced in some states by "claim for relief" or some equivalent term, the words "cause of action" have been bracketed to indicate that

the words may be replaced by an appropriate substitute to conform to local practice.

### **Comment to § 3-119 (A.C.A. § 4-3-119)**

This section (A.C.A. § 4-3-119) is a restatement of former Section 3-803.

### **Comment to § 3-201 (A.C.A. § 4-3-201)**

1. Subsections (a) and (b) (A.C.A. § 4-3-201(a) and (b)) are based in part on subsection (1) of former Section 3-202. A person can become holder of an instrument when the instrument is issued to that person, or the status of holder can arise as the result of an event that occurs after issuance. "Negotiation" is the term used in Article 3 (A.C.A. § 4-3-101 et seq.) to describe this post-issuance event. Normally, negotiation occurs as the result of a voluntary transfer of possession of an instrument by a holder to another person who becomes the holder as a result of the transfer. Negotiation always requires a change in possession of the instrument because nobody can be a holder without possessing the instrument, either directly or through an agent. But in some cases the transfer of possession is involuntary and in some cases the person transferring possession is not a holder. In defining "negotiation" former Section 3-202(1) used the word "transfer," an undefined term, and "delivery," defined in Section 1-201(14) (A.C.A. § 4-1-201(14)) to mean voluntary change of possession. Instead, subsections (a) and (b) (A.C.A. § 4-3-201(a) and (b)) use the term "transfer of possession" and, subsection (a) (A.C.A. § 4-3-201(a)) states that negotiation can occur by an involuntary transfer of possession. For example, if an instrument is payable to bearer and it is stolen by Thief or is found by Finder, Thief or Finder becomes the holder of the instrument when possession is obtained. In this case there is an involuntary transfer of possession that results in negotiation to Thief or Finder.

2. In most cases, negotiation occurs by

a transfer of possession by a holder or remitter. Remitter transactions usually involve a cashier's or teller's check. For example, Buyer buys goods from Seller and pays for them with a cashier's check of Bank that Buyer buys from Bank. The check is issued by Bank when it is delivered to Buyer, regardless of whether the check is payable to Buyer or to Seller. Section 3-105(a) (A.C.A. § 4-3-105(a)). If the check is payable to Buyer, negotiation to Seller is done by delivery of the check to Seller after it is indorsed by Buyer. It is more common, however, that the check when issued will be payable to Seller. In that case Buyer is referred to as the "remitter." Section 3-103(a)(11) (A.C.A. § 4-3-103(a)(11)). The remitter, although not a party to the check, is the owner of the check until ownership is transferred to Seller by delivery. This transfer is a negotiation because Seller becomes the holder of the check when Seller obtains possession. In some cases Seller may have acted fraudulently in obtaining possession of the check. In those cases Buyer may be entitled to rescind the transfer to Seller because of the fraud and assert a claim of ownership to the check under Section 3-306 (A.C.A. § 4-3-306) against Seller or a subsequent transferee of the check. Section 3-202(b) (A.C.A. § 4-3-202(b)) provides for rescission of negotiation, and that provision applies to rescission by a remitter as well as by a holder.

3. Other sections of Article 3 (A.C.A. § 4-3-101 et seq.) may modify the rule stated in the first sentence of subsection (b) (A.C.A. § 4-3-201(b)). See for example, Sections 3-404, 3-405 and 3-406 (A.C.A. §§ 4-3-404, 4-3-405, and 4-3-406).



**Comment to § 3-202 (A.C.A. § 4-3-202)**

*Prior Uniform Statutory Provision:* Sections 30, 31 and 32, Uniform Negotiable Instruments Law.

*Changes:* Combined and reworded; new provisions.

*Purposes of Changes and New Matter:* To make it clear that:

1. This section (A.C.A. § 4-3-202) is based on former Section 3-207. Subsection (2) of former Section 3-207 prohibited rescission of a negotiation against holders in due course. Subsection (b) of Section 3-202 (A.C.A. § 4-3-202(b)) extends this protection to payor banks.

2. Subsection (a) (A.C.A. § 4-3-202(a)) applies even though the lack of capacity or the illegality, is of a character which goes to the essence of the transaction and makes it entirely void. It is inherent in the character of negotiable instruments that any person in possession of an instrument which by its terms is payable to that person or to bearer is a holder and may be dealt with by anyone as a holder. The principle finds its most extreme application in the well settled rule that a holder in due course may take the instrument even from a thief and be protected against the claim of the rightful owner. The policy of subsection (a) (A.C.A. § 4-3-202(a)) is that any person to whom an instrument is

negotiated is a holder until the instrument has been recovered from that person's possession. The remedy of a person with a claim to an instrument is to recover the instrument by replevin or otherwise, to impound it or to enjoin its enforcement, collection or negotiation; to recover its proceeds from the holder; or to intervene in any action brought by the holder against the obligor. As provided in Section 3-305(c) (A.C.A. § 4-3-305(c)), the claim of the claimant is not a defense to the obligor unless the claimant defends the action.

3. There can be no rescission or other remedy against a holder in due course or a person who pays in good faith and without notice, even though the prior negotiation may have been fraudulent or illegal in its essence and entirely void. As against any other party the claimant may have any remedy permitted by law. This section (A.C.A. § 4-3-202) is not intended to specify what that remedy may be, or to prevent any court from imposing conditions or limitations such as prompt action or return of the consideration received. All such questions are left to the law of the particular jurisdiction. Section 3-202 (A.C.A. § 4-3-202) gives no right that would not otherwise exist. The section (A.C.A. § 4-3-202) is intended to mean that any remedies afforded by other law are cut off only by a holder in due course.

**Comment to § 3-203 (A.C.A. § 4-3-203)**

1. Section 3-203 (A.C.A. § 4-3-203) is based on former Section 3-201 which stated that a transferee received such rights as the transferor had. The former section was confusing because some rights of the transferor are not vested in the transferee unless the transfer is a negotiation. For example, a transferee that did not become the holder could not negotiate the instrument, a right that the transferor had. Former Section 3-201 did not define "transfer." Subsection (a) (A.C.A. § 4-3-203(a)) defines transfer by limiting it to cases in which possession of the instrument is delivered for the purpose of giving to the person receiving delivery the right to enforce the instrument.

Although transfer of an instrument might mean in a particular case that title to the instrument passes to the trans-

feree, that result does not follow in all cases. The right to enforce an instrument and ownership of the instrument are two different concepts. A thief who steals a check payable to bearer becomes the holder of the check and a person entitled to enforce it, but does not become the owner of the check. If the thief transfers the check to a purchaser the transferee obtains the right to enforce the check. If the purchaser is not a holder in due course, the owner's claim to the check may be asserted against the purchaser. Ownership rights in instruments may be determined by principles of the law of property, independent of Article 3 (A.C.A. § 4-3-101 et seq.), which do not depend upon whether the instrument was transferred under Section 3-203 (A.C.A. § 4-3-203). Moreover, a person who has an ownership

right in an instrument might not be a person entitled to enforce the instrument. For example, suppose X is the owner and holder of an instrument payable to X. X sells the instrument to Y but is unable to deliver immediate possession to Y. Instead, X signs a document conveying all of X's right, title, and interest in the instrument to Y. Although the document may be effective to give Y a claim to ownership of the instrument, Y is not a person entitled to enforce the instrument until Y obtains possession of the instrument. No transfer of the instrument occurs under Section 3-203(a) (A.C.A. § 4-3-203(a)) until it is delivered to Y.

An instrument is a reified right to payment. The right is represented by the instrument itself. The right to payment is transferred by delivery of possession of the instrument "by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument." The quoted phrase excludes issue of an instrument, defined in Section 3-105 (A.C.A. § 4-3-105), and cases in which a delivery of possession is for some purpose other than transfer of the right to enforce. For example, if a check is presented for payment by delivering the check to the drawee, no transfer of the check to the drawee occurs because there is no intent to give the drawee the right to enforce the check.

2. Subsection (b) (A.C.A. § 4-3-203(b)) states that transfer vests in the transferee any right of the transferor to enforce the instrument "including any right as a holder in due course." If the transferee is not a holder because the transferor did not indorse, the transferee is nevertheless a person entitled to enforce the instrument under Section 3-301 (A.C.A. § 4-3-301) if the transferor was a holder at the time of transfer. Although the transferee is not a holder, under subsection (b) (A.C.A. § 4-3-203(b)) the transferee obtained the rights of the transferor as holder. Because the transferee's rights are derivative of the transferor's rights, those rights must be proved. Because the transferee is not a holder, there is no presumption under Section 3-308 (A.C.A. § 4-3-308) that the transferee, by producing the instrument, is entitled to payment. The instrument, by its terms, is not payable to the transferee and the transferee must account for possession of the unindorsed instrument by

proving the transaction through which the transferee acquired it. Proof of a transfer to the transferee by a holder is proof that the transferee has acquired the rights of a holder. At that point the transferee is entitled to the presumption under Section 3-308 (A.C.A. § 4-3-308).

Under subsection (b) (A.C.A. § 4-3-203(b)) a holder in due course that transfers an instrument transfers those rights as a holder in due course to the purchaser. The policy is to assure the holder in due course a free market for the instrument. There is one exception to this rule stated in the concluding clause of subsection (b) (A.C.A. § 4-3-203(b)). A person who is party to fraud or illegality affecting the instrument is not permitted to wash the instrument clean by passing it into the hands of a holder in due course and then repurchasing it.

3. Subsection (c) (A.C.A. § 4-3-203(c)) applies only to a transfer for value. It applies only if the instrument is payable to order or specially indorsed to the transferor. The transferee acquires, in the absence of a contrary agreement, the specifically enforceable right to the indorsement of the transferor. Unless otherwise agreed, it is a right to the general indorsement of the transferor with full liability as indorser, rather than to an indorsement without recourse. The question may arise if the transferee has paid in advance and the indorsement is omitted fraudulently or through oversight. A transferor who is willing to indorse only without recourse or unwilling to indorse at all should make those intentions clear before transfer. The agreement of the transferee to take less than an unqualified indorsement need not be an express one, and the understanding may be implied from conduct, from past practice, or from the circumstances of the transaction. Subsection (c) (A.C.A. § 4-3-203(c)) provides that there is no negotiation of the instrument until the indorsement by the transferor is made. Until that time the transferee does not become a holder, and if earlier notice of a defense or claim is received, the transferee does not qualify as a holder in due course under Section 3-302 (A.C.A. § 4-3-302).

4. The operation of Section 3-203 (A.C.A. § 4-3-203) is illustrated by the following cases. In each case Payee, by fraud, induced Maker to issue a note to Payee. The fraud is a defense to the obli-



gation of Maker to pay the note under Section 3-305(a)(2) (A.C.A. § 4-3-305(a)(2)).

*Case # 1.* Payee negotiated the note to X who took as a holder in due course. After the instrument became overdue X negotiated the note to Y who had notice of the fraud. Y succeeds to X's rights as a holder in due course and takes free of Maker's defense of fraud.

*Case # 2.* Payee negotiated the note to X who took as a holder in due course. Payee then repurchased the note from X. Payee does not succeed to X's rights as a holder in due course and is subject to Maker's defense of fraud.

*Case # 3.* Payee negotiated the note to X who took as a holder in due course. X sold the note to Purchaser who received possession. The note, however, was indorsed to X and X failed to indorse it. Purchaser is a person entitled to enforce the instrument under Section 3-301 (A.C.A. § 4-3-301) and succeeds to the rights of X as holder in due course. Purchaser is not a holder, however, and under Section 3-308 (A.C.A. § 4-3-308) Purchaser will have to prove the transaction with X under which the rights of X as holder in due course were acquired.

*Case # 4.* Payee sold the note to Purchaser who took for value, in good faith and without notice of the defense of Maker. Purchaser received possession of the note but Payee neglected to indorse it. Purchaser became a person entitled to enforce the

instrument but did not become the holder because of the missing indorsement. If Purchaser received notice of the defense of Maker before obtaining the indorsement of Payee, Purchaser cannot become a holder in due course because at the time notice was received the note had not been negotiated to Purchaser. If indorsement by Payee was made after Purchaser received notice, Purchaser had notice of the defense when it became the holder.

5. Subsection (d) (A.C.A. § 4-3-203(d)) restates former Section 3-202(3). The cause of action on an instrument cannot be split. Any indorsement which purports to convey to any party less than the entire amount of the instrument is not effective for negotiation. This is true of either "Pay A one-half," or "Pay A two-thirds and B one-third." Neither A nor B becomes a holder. On the other hand an indorsement reading merely "Pay A and B" is effective, since it transfers the entire cause of action to A and B as tenants in common. An indorsement purporting to convey less than the entire instrument does, however, operate as a partial assignment of the cause of action. Subsection (d) (A.C.A. § 4-3-203(d)) makes no attempt to state the legal effect of such an assignment, which is left to other law. A partial assignee of an instrument has rights only to the extent the applicable law gives rights, either at law or in equity, to a partial assignee.

### Comment to § 3-204 (A.C.A. § 4-3-204)

1. Subsection (a) (A.C.A. § 4-3-204(a)) is a definition of "indorsement," a term which was not defined in former Article 3. Indorsement is defined in terms of the purpose of the signature. If a blank or special indorsement is made to give rights as a holder to a transferee the indorsement is made for the purpose of negotiating the instrument. Subsection (a)(i) (A.C.A. § 4-3-204(a)(i)). If the holder of a check has an account in the drawee bank and wants to be sure that payment of the check will be made by credit to the holder's account, the holder can indorse the check by signing the holder's name with the accompanying words "for deposit only"

before presenting the check for payment to the drawee bank. In that case the purpose of the quoted words is to restrict payment of the instrument. Subsection (a)(ii) (A.C.A. § 4-3-204(a)(ii)). If X wants to guarantee payment of a note signed by Y as maker, X can do so by signing X's name to the back of the note as an indorsement. This indorsement is known as an anomalous indorsement (Section 3-205(d)) (A.C.A. § 4-3-205(d)) and is made for the purpose of incurring indorser's liability on the note. Subsection (a)(iii) (A.C.A. § 4-3-204(a)(iii)). In some cases an indorsement may serve more than one purpose. For example, if the holder of a check deposits

it to the holder's account in a depository bank for collection and indorses the check by signing the holder's name with the accompanying words "for deposit only" the purpose of the indorsement is both to negotiate the check to the depository bank and to restrict payment of the check.

The "but" clause of the first sentence of subsection (a) (A.C.A. § 4-3-204(a)) elaborates on former Section 3-402. In some cases it may not be clear whether a signature was meant to be that of an indorser, a party to the instrument in some other capacity such as drawer, maker or acceptor, or a person who was not signing as a party. The general rule is that a signature is an indorsement if the instrument does not indicate an unambiguous intent of the signer not to sign as an indorser. Intent may be determined by words accompanying the signature, the place of signature, or other circumstances. For example, suppose a depository bank gives cash for a check properly indorsed by the payee. The bank requires the payee's employee to sign the back of the check as evidence that the employee received the cash. If the signature consists only of the initials of the employee it is not reasonable to assume that it was meant to be an indorsement. If there was a full signature but accompanying words indicated that it was meant as a receipt for the cash given for the check, it is not an indorsement. If the signature is not qualified in any way and appears in the place normally used for indorsements, it may be an indorsement even though the signer intended the signature to be a receipt. To take another example, suppose the drawee of a draft signs the draft on the back in the space usually used for indorsements. No words accompany the signature. Since the drawee has no reason to sign a draft unless the intent is to accept the draft, the signature is effective as an acceptance. Custom and usage may be used to determine intent. For example, by long-established custom and usage, a signature in the lower right hand corner of an instrument indicates an intent to sign as the maker of a note or the drawer of a draft. Any similar clear indication of an intent to sign in some other capacity or for some other purpose may establish that a signature is not an indorsement. For example, if the owner of a traveler's check countersigns the check in the process of negotiat-

ing it, the countersignature is not an indorsement. The countersignature is a condition to the issuer's obligation to pay and its purpose is to provide a means of verifying the identity of the person negotiating the traveler's check by allowing comparison of the specimen signature and the countersignature. The countersignature is not necessary for negotiation and the signer does not incur indorser's liability. See Comment 2 to Section 3-106 (A.C.A. § 4-3-106).

The last sentence of subsection (a) (A.C.A. § 4-3-204(a)) is based on subsection (2) of former Section 3-202. An indorsement on an allonge is valid even though there is sufficient space on the instrument for an indorsement.

2. Assume that Payee indorses a note to Creditor as security for a debt. Under subsection (b) of Section 3-203 (A.C.A. § 4-3-203(b)) Creditor takes Payee's rights to enforce or transfer the instrument subject to the limitations imposed by Article 9 (A.C.A. § 4-9-101 et seq.). Subsection (c) of Section 3-204 (A.C.A. § 4-3-204(c)) makes clear that Payee's indorsement to Creditor, even though it mentions creation of a security interest, is an unqualified indorsement that gives to Creditor the right to enforce the note as its holder.

3. Subsection (d) (A.C.A. § 4-3-204(d)) is a restatement of former Section 3-203. Section 3-110(a) (A.C.A. § 4-3-110(a)) states that an instrument is payable to the person intended by the person signing as or in the name or behalf of the issuer even if that person is identified by a name that is not the true name of the person. In some cases the name used in the instrument is a misspelling of the correct name and in some cases the two names may be entirely different. The payee may indorse in the name used in the instrument, in the payee's correct name, or in both. In each case the indorsement is effective. But because an indorsement in a name different from that used in the instrument may raise a question about its validity and an indorsement in a name that is not the correct name of the payee may raise a problem of identifying the indorser, the accepted commercial practice is to indorse in both names. Subsection (d) (A.C.A. § 4-3-204(d)) allows a person paying or taking the instrument for value or collection to require indorsement in both names.



**Comment to § 3-205 (A.C.A. § 4-3-205)**

1. Subsection (a) (A.C.A. § 4-3-205(a)) is based on subsection (1) of former Section 3-204. It states the test of a special indorsement to be whether the indorsement identifies a person to whom the instrument is payable. Section 3-110 (A.C.A. § 4-3-110) states rules for identifying the payee of an instrument. Section 3-205(a) (A.C.A. § 4-3-205(a)) incorporates the principles stated in Section 3-110 (A.C.A. § 4-3-110) in identifying an indorsee. The language of Section 3-110 (A.C.A. § 4-3-110) refers to language used by the issuer of the instrument. When that section is used with respect to an indorsement, Section 3-110 (A.C.A. § 4-3-110) must be read as referring to the language used by the indorser.

2. Subsection (b) (A.C.A. § 4-3-205(b)) is based on subsection (2) of former Section 3-204. An indorsement made by the holder is either a special or blank indorsement. If the indorsement is made by a holder and is not a special indorsement, it is a blank indorsement. For example, the holder of an instrument, intending to make a special indorsement, writes the words "Pay to the order of" without completing the indorsement by writing the name of the indorsee. The holder's signature appears under the quoted words. The indorsement is not a special indorsement because it does not identify a person to whom it makes the instrument payable.

Since it is not a special indorsement it is a blank indorsement and the instrument is payable to bearer. The result is analogous to that of a check in which the name of the payee is left blank by the drawer. In that case the check is payable to bearer. See the last paragraphs of Comment 2 to Section 3-115 (A.C.A. § 4-3-115).

A blank indorsement is usually the signature of the indorser on the back of the instrument without other words. Subsection (c) (A.C.A. § 4-3-205(c)) is based on subsection (3) of former Section 3-204. A "restrictive indorsement" described in Section 3-206 (A.C.A. § 4-3-206) can be either a blank indorsement or a special indorsement. "Pay to T, in trust for B" is a restrictive indorsement. It is also a special indorsement because it identifies T as the person to whom the instrument is payable. "For deposit only" followed by the signature of the payee of a check is a restrictive indorsement. It is also a blank indorsement because it does not identify the person to whom the instrument is payable.

3. The only effect of an "anomalous indorsement," defined in subsection (d) (A.C.A. § 4-3-205(d)), is to make the signer liable on the instrument as an indorser. Such an indorsement is normally made by an accommodation party. Section 3-419 (A.C.A. § 4-3-419).

**Comment to § 3-206 (A.C.A. § 4-3-206)**

1. This section (A.C.A. § 4-3-206) replaces former Sections 3-205 and 3-206 and clarifies the law of restrictive indorsements.

2. Subsection (a) (A.C.A. § 4-3-206(a)) provides that an indorsement that purports to limit further transfer or negotiation is ineffective to prevent further transfer or negotiation. If a payee indorses "Pay A only," A may negotiate the instrument to subsequent holders who may ignore the restriction on the indorsement. Subsection (b) (A.C.A. § 4-3-206(b)) provides that an indorsement that states a condition to the right of a holder to receive payment is ineffective to condition payment. Thus if a payee indorses "Pay A if A ships goods complying with our contract," the right of A to enforce the instrument is

not affected by the condition. In the case of a note, the obligation of the maker to pay A is not affected by the indorsement. In the case of a check, the drawee can pay A without regard to the condition, and if the check is dishonored the drawer is liable to pay A. If the check was negotiated by the payee to A in return for a promise to perform a contract and the promise was not kept, the payee would have a defense or counterclaim against A if the check were dishonored and A sued the payee as indorser, but the payee would have that defense or counterclaim whether or not the condition to the right of A was expressed in the indorsement. Former Section 3-206 treated a conditional indorsement like indorsements for deposit or collection. In revised Article 3 (A.C.A. § 4-

3-101 et seq.), Section 3-206(b) (A.C.A. § 4-3-206(b)) rejects that approach and makes the conditional indorsement ineffective with respect to parties other than the indorser and indorsee. Since the indorsements referred to in subsections (a) and (b) (A.C.A. § 4-3-206(a) and (b)) are not effective as restrictive indorsements, they are no longer described as restrictive indorsements.

3. The great majority of restrictive indorsements are those that fall within subsection (c) (A.C.A. § 4-3-206(c)) which continues previous law. The depositary bank or the payor bank, if it takes the check for immediate payment over the counter, must act consistently with the indorsement, but an intermediary bank or payor bank that takes the check from a collecting bank is not affected by the indorsement. Any other person is also bound by the indorsement. For example, suppose a check is payable to X, who indorses in blank but writes above the signature the words "For deposit only." The check is stolen and is cashed at a grocery store by the thief. The grocery store indorses the check and deposits it in Depositary Bank. The account of the grocery store is credited and the check is forwarded to Payor Bank which pays the check. Under subsection (c) (A.C.A. § 4-3-206(c)), the grocery store and Depositary Bank are converters of the check because X did not receive the amount paid for the check. Payor Bank and any intermediary bank in

the collection process are not liable to X. This Article (Chapter) does not displace the law of waiver as it may apply to restrictive indorsements. The circumstances under which a restrictive indorsement may be waived by the person who made it is not determined by this Article (Chapter).

4. Subsection (d) (A.C.A. § 4-3-206(d)) replaces subsection (4) of former Section 3-206. Suppose Payee indorses a check "Pay to T in trust for B." T indorses in blank and delivers it to (a) Holder for value; (b) Depositary Bank for collection; or (c) Payor Bank for payment. In each case these takers can safely pay T so long as they have no notice under Section 3-307 (A.C.A. § 4-3-307) of any breach of fiduciary duty that T may be committing. For example, under subsection (b) of Section 3-307 (A.C.A. § 4-3-307(b)) these takers have notice of a breach of trust if the check was taken in any transaction known by the taker to be for T's personal benefit. Subsequent transferees of the check from Holder or Depositary Bank are not affected by the restriction unless they have knowledge that T dealt with the check in breach of trust.

5. Subsection (f) (A.C.A. § 4-3-206(f)) allows a restrictive indorsement to be used as a defense by a person obliged to pay the instrument if that person would be liable for paying in violation of the indorsement.

### Comment to § 3-207 (A.C.A. § 4-3-207)

Section 3-207 (A.C.A. § 4-3-207) restates former Section 3-208. Reacquisition refers to cases in which a former holder reacquires the instrument either by negotiation from the present holder or by a transfer other than negotiation. If the reacquisition is by negotiation, the former holder reacquires the status of holder. Although Section 3-207 (A.C.A. § 4-3-207) allows the holder to cancel all indorsements made after the holder first acquired holder status, cancellation is not necessary. Status of holder is not affected whether or not cancellation is made. But if the reacquisition is not the result of negotiation the former holder can obtain holder status only by striking the former holder's indorsement and any subsequent indorsements. The latter case is an excep-

tion to the general rule that if an instrument is payable to an identified person, the indorsement of that person is necessary to allow a subsequent transferee to obtain the status of holder. Reacquisition without indorsement by the person to whom the instrument is payable is illustrated by two examples:

*Case # 1.* X, a former holder, buys the instrument from Y, the present holder. Y delivers the instrument to X but fails to indorse it. Negotiation does not occur because the transfer of possession did not result in X's becoming holder. Section 3-201(a) (A.C.A. § 4-3-201(a)). The instrument by its terms is payable to Y, not to X. But X can obtain the status of holder by



striking X's indorsement and all subsequent indorsements. When these indorsements are struck, the instrument by its terms is payable either to X or to bearer, depending upon how X originally became holder. In either case X becomes holder. Section 1-201(20) (A.C.A. § 4-1-201(20)).

*Case # 2.* X, the holder of an instrument payable to X, negotiates it to Y by special indorsement. The negotiation is part of an underlying transaction between X and Y. The underlying transaction is rescinded by agreement of X and Y, and Y returns the instrument without Y's indorsement. The analysis is the same as that in Case # 1. X can obtain holder status by canceling X's indorsement to Y.

In Case # 1 and Case # 2, X acquired

ownership of the instrument after reacquisition, but X's title was clouded because the instrument by its terms was not payable to X. Normally, X can remedy the problem by obtaining Y's indorsement, but in some cases X may not be able to conveniently obtain that indorsement. Section 3-207 (A.C.A. § 4-3-207) is a rule of convenience which relieves X of the burden of obtaining an indorsement that serves no substantive purpose. The effect of cancellation of any indorsement under Section 3-207 (A.C.A. § 4-3-207) is to nullify it. Thus, the person whose indorsement is canceled is relieved of indorser's liability. Since cancellation is notice of discharge, discharge is effective even with respect to the rights of a holder in due course. Sections 3-601 and 3-604 (A.C.A. §§ 4-3-601 and 4-3-604).

#### **Comment to § 3-301 (A.C.A. § 4-3-301)**

This section (A.C.A. § 4-3-301) replaces former Section 3-301 that stated the rights of a holder. The rights stated in former Section 3-301 to transfer, negotiate, enforce, or discharge an instrument are stated in other sections of Article 3 (A.C.A. § 4-3-101 et seq.). In revised Article 3 (A.C.A. § 4-3-101 et seq.), Section 3-301 (A.C.A. § 4-3-301) defines "person entitled to enforce" an instrument. The definition recognizes that enforcement is not limited to holders. The quoted phrase

includes a person enforcing a lost or stolen instrument. Section 3-309 (A.C.A. § 4-3-309). It also includes a person in possession of an instrument who is not a holder. A nonholder in possession of an instrument includes a person that acquired rights of a holder by subrogation or under Section 3-203(a) (A.C.A. § 4-3-203(a)). It also includes any other person who under applicable law is a successor to the holder or otherwise acquires the holder's rights.

#### **Comment to § 3-302 (A.C.A. § 4-3-302)**

1. Subsection (a)(1) (A.C.A. § 4-3-302(a)(1)) is a return to the N.I.L. rule that the taker of an irregular or incomplete instrument is not a person the law should protect against defenses of the obligor or claims of prior owners. This reflects a policy choice against extending the holder in due course doctrine to an instrument that is so incomplete or irregular "as to call into question its authenticity." The term "authenticity" is used to make it clear that the irregularity or incompleteness must indicate that the instrument may not be what it purports to be. Persons who purchase or pay such instruments should do so at their own risk. Under subsection (1) of former Section 3-304, irregularity or incompleteness

gave a purchaser notice of a claim or defense. But it was not clear from that provision whether the claim or defense had to be related to the irregularity or incomplete aspect of the instrument. This ambiguity is not present in subsection (a)(1) (A.C.A. § 4-3-302(a)(1)).

2. Subsection (a)(2) (A.C.A. § 4-3-302(a)(2)) restates subsection (1) of former Section 3-302. Section 3-305(a) (A.C.A. § 4-3-305(a)) makes a distinction between defenses to the obligation to pay an instrument and claims in recoupment by the maker or drawer that may be asserted to reduce the amount payable on the instrument. Because of this distinction, which was not made in former Article 3, the reference in subsection (a)(2)(vi) (A.C.A.

§ 4-3-302(a)(2)(vi)) is to both a defense and a claim in recoupment. Notice of forgery or alteration is stated separately because forgery and alteration are not technically defenses under subsection (a) of Section 3-305 (A.C.A. § 4-3-305(a)).

3. Discharge is also separately treated in the first sentence of subsection (b) (A.C.A. § 4-3-302(b)). Except for discharge in an insolvency proceeding, which is specifically stated to be a real defense in Section 3-305(a)(1) (A.C.A. § 4-3-305(a)(1)), discharge is not expressed in Article 3 (A.C.A. § 4-3-101 et seq.) as a defense and is not included in Section 3-305(a)(2) (A.C.A. § 4-3-305(a)(2)). Discharge is effective against anybody except a person having rights of a holder in due course who took the instrument without notice of the discharge. Notice of discharge does not disqualify a person from becoming a holder in due course. For example, a check certified after it is negotiated by the payee may subsequently be negotiated to a holder. If the holder had notice that the certification occurred after negotiation by the payee, the holder necessarily had notice of the discharge of the payee as indorser. Section 3-415(d) (A.C.A. § 4-3-415(d)). Notice of that discharge does not prevent the holder from becoming a holder in due course, but the discharge is effective against the holder. Section 3-601(b) (A.C.A. § 4-3-601(b)). Notice of a defense under Section 3-305(a)(1) (A.C.A. § 4-3-305(a)(1)) of a maker, drawer or acceptor based on a bankruptcy discharge is different. There is no reason to give holder in due course status to a person with notice of that defense. The second sentence of subsection (b) (A.C.A. § 4-3-302(b)) is from former Section 3-304(5).

4. Professor Britton in his treatise *Bills and Notes* 309 (1961) stated: "A substantial number of decisions before the [N.I.L.] indicates that at common law there was nothing in the position of the payee as such which made it impossible for him to be a holder in due course." The courts were divided, however, about whether the payee of an instrument could be a holder in due course under the N.I.L. Some courts read N.I.L. § 52(4) to mean that a person could be a holder in due course only if the instrument was "negotiated" to that person. N.I.L. § 30 stated that "an instrument is negotiated when it is trans-

ferred from one person to another in such manner as to constitute the transferee the holder thereof." Normally, an instrument is "issued" to the payee; it is not transferred to the payee. N.I.L. § 191 defined "issue" as the "first delivery of the instrument... to a person who takes it as a holder." Thus, some courts concluded that the payee never could be a holder in due course. Other courts concluded that there was no evidence that the N.I.L. was intended to change the common law rule that the payee could be a holder in due course. Professor Britton states on p. 318: "The typical situations which raise the [issue] are those where the defense of a maker is interposed because of fraud by a [maker who is] principal debtor ... against a surety co-maker, or where the defense of fraud by a purchasing remitter is interposed by the drawer of the instrument against the good faith purchasing payee."

Former Section 3-302(2) stated: "A payee may be a holder in due course." This provision was intended to resolve the split of authority under the N.I.L. It made clear that there was no intent to change the common-law rule that allowed a payee to become a holder in due course. See Comment 2 to former Section 3-302. But there was no need to put subsection (2) in former Section 3-302 because the split in authority under the N.I.L. was caused by the particular wording of N.I.L. § 52(4). The troublesome language in that section was not repeated in former Article 3 nor is it repeated in revised Article 3 (A.C.A. § 4-3-101 et seq.). Former Section 3-302(2) has been omitted in revised Article 3 (A.C.A. § 4-3-101 et seq.) because it is surplusage and may be misleading. The payee of an instrument can be a holder in due course, but use of the holder-in-due-course doctrine by the payee of an instrument is not the normal situation.

The primary importance of the concept of holder in due course is with respect to assertion of defenses or claims in recoupment (Section 3-305) (A.C.A. § 4-3-305) and of claims to the instrument (Section 3-306) (A.C.A. § 4-3-306). The holder-in-due-course doctrine assumes the following case as typical. Obligor issues a note or check to Obligee. Obligor is the maker of the note or drawer of the check. Obligee is the payee. Obligor has some defense to Obligor's obligation to pay the instrument. For example, Obligor issued the



instrument for goods that Obligee promised to deliver. Obligee never delivered the goods. The failure of Obligee to deliver the goods is a defense. Section 3-303(b) (A.C.A. § 4-3-303(b)). Although Obligor has a defense against Obligee, if the instrument is negotiated to Holder and the requirements of subsection (a) (A.C.A. § 4-3-302(a)) are met, Holder may enforce the instrument against Obligor free of the defense. Section 3-305(b) (A.C.A. § 4-3-305(b)). In the typical case the holder in due course is not the payee of the instrument. Rather, the holder in due course is an immediate or remote transferee of the payee. If Obligor in our example is the only obligor on the check or note, the holder-in-due-course doctrine is irrelevant in determining rights between Obligor and Obligee with respect to the instrument.

But in a small percentage of cases it is appropriate to allow the payee of an instrument to assert rights as a holder in due course. The cases are like those referred to in the quotation from Professor Britton referred to above, or other cases in which conduct of some third party is the basis of the defense of the issuer of the instrument. The following are examples:

*Case # 1.* Buyer pays for goods bought from Seller by giving to Seller a cashier's check bought from Bank. Bank has a defense to its obligation to pay the check because Buyer bought the check from Bank with a check known to be drawn on an account with insufficient funds to cover the check. If Bank issued the check to Buyer as payee and Buyer indorsed it over to Seller, it is clear that Seller can be a holder in due course taking free of the defense if Seller had no notice of the defense. Seller is a transferee of the check. There is no good reason why Seller's position should be any different if Bank drew the check to the order of Seller as payee. In that case, when Buyer took delivery of the check from Bank, Buyer became the owner of the check even though Buyer was not the holder. Buyer was a remitter. Section 3-103(a)(11) (A.C.A. § 4-3-103(a)(11)). At that point nobody was the holder. When Buyer delivered the check to Seller, ownership of the check was transferred to Seller who

also became the holder. This is a negotiation. Section 3-201 (A.C.A. § 4-3-201). The rights of Seller should not be affected by the fact that in one case the negotiation to Seller was by a holder and in the other case the negotiation was by a remitter. Moreover, it should be irrelevant whether Bank delivered the check to Buyer and Buyer delivered it to Seller or whether Bank delivered it directly to Seller. In either case Seller can be a holder in due course that takes free of Bank's defense.

*Case # 2.* X fraudulently induces Y to join X in a spurious venture to purchase a business. The purchase is to be financed by a bank loan for part of the price. Bank lends money to X and Y by deposit in a joint account of X and Y who sign a note payable to Bank for the amount of the loan. X then withdraws the money from the joint account and absconds. Bank acted in good faith and without notice of the fraud of X against Y. Bank is payee of the note executed by Y, but its right to enforce the note against Y should not be affected by the fact that Y was induced to execute the note by the fraud of X. Bank can be a holder in due course that takes free of the defense of Y. Case # 2 is similar to Case # 1. In each case the payee of the instrument has given value to the person committing the fraud in exchange for the obligation of the person against whom the fraud was committed. In each case the payee was not party to the fraud and had no notice of it.

Suppose in Case # 2 that the note does not meet the requirements of Section 3-104(a) (A.C.A. § 4-3-104(a)) and thus is not a negotiable instrument covered by Article 3 (A.C.A. § 4-3-101 et seq.). In that case, Bank cannot be a holder in due course but the result should be the same. Bank's rights are determined by general principles of contract law. Restatement Second, Contracts § 164(2) governs the case. If Y is induced to enter into a contract with Bank by a fraudulent misrepresentation by X, the contract is voidable by Y unless Bank "in good faith and without reason to know of the misrepresentation either gives value or relies materially

on the transaction." Comment E to § 164(2) states:

"This is the same principle that protects an innocent person who purchases goods or commercial paper in good faith, without notice and for value from one who obtained them from the original owner by a misrepresentation. See Uniform Commercial Code § 2-403(1), 3-305 (A.C.A. §§ 4-2-403(1) and 4-3-305). In the cases that fall within [§ 164(2)], however, the innocent person deals directly with the recipient of the misrepresentation, which is made by one not a party to the contract."

The same result follows in Case # 2 if Y had been induced to sign the note as an accommodation party (Section 3-419) (A.C.A. § 4-3-419). If Y signs as co-maker of a note for the benefit of X, Y is a surety with respect to the obligation of X to pay the note but is liable as maker of the note to pay Bank. Section 3-419(b) (A.C.A. § 4-3-419(b)). If Bank is a holder in due course, the fraud of X cannot be asserted against Bank under Section 3-305(b) (A.C.A. § 4-3-305(b)). But the result is the same without resort to holder-in-due-course doctrine. If the note is not a negotiable instrument governed by Article 3 (A.C.A. § 4-3-101 et seq.), general rules of suretyship apply. Restatement, Security § 119 states that the surety (Y) cannot assert a defense against the creditor (Bank) based on the fraud of the principal (X) if the creditor "without knowledge of the fraud ... extended credit to the principal on the security of the surety's promise...." The underlying principle of § 119 is the same as that of § 164(2) of Restatement Second, Contracts.

*Case # 3.* Corporation draws a check payable to Bank. The check is given to an officer of Corporation who is instructed to deliver it to Bank in payment of a debt owed by Corporation to Bank. Instead, the officer, intending to defraud Corporation, delivers the check to Bank in payment of the officer's personal debt, or the check is delivered to Bank for deposit to the officer's personal account. If Bank obtains payment of the check, Bank has received funds of Corporation which have been used for the personal ben-

efit of the officer. Corporation in this case will assert a claim to the proceeds of the check against Bank. If Bank was a holder in due course of the check, it took the check free of Corporation's claim. Section 3-306 (A.C.A. § 4-3-306). The issue in this case is whether Bank had notice of the claim when it took the check. If Bank knew that the officer was a fiduciary with respect to the check, the issue is governed by Section 3-307 (A.C.A. § 4-3-307).

*Case # 4.* Employer, who owed money to X, signed a blank check and delivered it to Secretary with instructions to complete the check by typing in X's name and the amount owed to X. Secretary fraudulently completed the check by typing in the name of Y, a creditor to whom Secretary owed money. Secretary then delivered the check to Y in payment of Secretary's debt. Y obtained payment of the check. This case is similar to Case # 3. Since Secretary was authorized to complete the check, Employer is bound by Secretary's act in making the check payable to Y. The drawee bank properly paid the check. Y received funds of Employer which were used for the personal benefit of Secretary. Employer asserts a claim to these funds against Y. If Y is a holder in due course, Y takes free of the claim. Whether Y is a holder in due course depends upon whether Y had notice of Employer's claim.

5. Subsection (c) (A.C.A. § 4-3-302(c)) is based on former Section 3-302(3). Like former Section 3-302(3), subsection (c) (A.C.A. § 4-3-302(c)) is intended to state existing case law. It covers a few situations in which the purchaser takes an instrument under unusual circumstances. The purchaser is treated as a successor in interest to the prior holder and can acquire no better rights. But if the prior holder was a holder in due course, the purchaser obtains rights of a holder in due course.

Subsection (c) (A.C.A. § 4-3-302(c)) applies to a purchaser in an execution sale or sale in bankruptcy. It applies equally to an attaching creditor or any other person who acquires the instrument by legal process or to a representative, such as an



executor, administrator, receiver or assignee for the benefit of creditors, who takes the instrument as part of an estate. Subsection (c) (A.C.A. § 4-3-302(c)) applies to bulk purchases lying outside of the ordinary course of business of the seller. For example, it applies to the purchase by one bank of a substantial part of the paper held by another bank which is threatened with insolvency and seeking to liquidate its assets. Subsection (c) (A.C.A. § 4-3-302(c)) would also apply when a new partnership takes over for value all of the assets of an old one after a new member has entered the firm, or to a reorganized or consolidated corporation taking over the assets of a predecessor.

In the absence of controlling state law to the contrary, subsection (c) (A.C.A. § 4-3-302(c)) applies to a sale by a state bank commissioner of the assets of an insolvent bank. However, subsection (c) (A.C.A. § 4-3-302(c)) may be preempted by federal law if the Federal Deposit Insurance Corporation takes over an insolvent bank. Under the governing federal law, the FDIC and similar financial institution insurers are given holder in due course status and that status is also acquired by their assignees under the shelter doctrine.

6. Subsections (d) and (e) (A.C.A. § 4-3-302(d) and (e)) clarify two matters not specifically addressed by former Article 3:

*Case # 5.* Payee negotiates a \$1,000 note to Holder who agrees to pay \$900 for it. After paying \$500, Holder learns that Payee defrauded Maker in the transaction giving rise to the note. Under subsection (d) (A.C.A. § 4-3-302(d)) Holder may assert rights as a holder in due course to the extent of \$555.55 ( $\$500 \div \$900 = .555 \times \$1,000$

= \$555.55). This formula rewards Holder with a ratable portion of the bargained for profit.

*Case # 6.* Payee negotiates a note of Maker for \$1,000 to Holder as security for payment of Payee's debt to Holder of \$600. Maker has a defense which is good against Payee but of which Holder has no notice. Subsection (e) (A.C.A. § 4-3-302(e)) applies. Holder may assert rights as a holder in due course only to the extent of \$600. Payee does not get the benefit of the holder-in-due-course status of Holder. With respect to \$400 of the note, Maker may assert any rights that Maker has against Payee. A different result follows if the payee of a note negotiated it to a person who took it as a holder in due course and that person pledged the note as security for a debt. Because the defense cannot be asserted against the pledgor, the pledgee can assert rights as a holder in due course for the full amount of the note for the benefit of both the pledgor and the pledgee.

7. There is a large body of state statutory and case law restricting the use of the holder in due course doctrine in consumer transactions as well as some business transactions that raise similar issues. Subsection (g) (A.C.A. § 4-3-302(g)) subordinates Article 3 (A.C.A. § 4-3-101 et seq.) to that law and any other similar law that may evolve in the future. Section 3-106(d) (A.C.A. § 4-3-106(d)) also relates to statutory or administrative law intended to restrict use of the holder-in-due-course doctrine. See comment 3 to Section 3-106 (A.C.A. § 4-3-106).

### Comment to § 3-303 (A.C.A. § 4-3-303)

1. Subsection (a) (A.C.A. § 4-3-303(a)) is a restatement of former Section 3-303 and subsection (b) (A.C.A. § 4-3-303(b)) replaces former Section 3-408. The distinction between value and consideration in Article 3 (A.C.A. § 4-3-101 et seq.) is a very fine one. Whether an instrument is taken for value is relevant to the issue of whether a holder is a holder in due course. If an instrument is not issued for consideration the issuer has a defense to the obligation to pay the instrument. Consid-

eration is defined in subsection (b) (A.C.A. § 4-3-303(b)) as "any consideration sufficient to support a simple contract." The definition of value in Section 1-201(44) (A.C.A. § 4-1-201(44)), which doesn't apply to Article 3 (A.C.A. § 4-3-101 et seq.), includes "any consideration sufficient to support simple contract." Thus, outside Article 3 (A.C.A. § 4-3-101 et seq.), anything that is consideration is also value. A different rule applies in Article 3 (A.C.A. § 4-3-101 et seq.). Subsection (b) of Sec-

tion 3-303 (A.C.A. § 4-3-303(b)) states that if an instrument is issued for value it is also issued for consideration.

*Case #1.* X owes Y \$1,000. The debt is not represented by a note. Later X issues a note to Y for the debt. Under subsection (a)(3) (A.C.A. § 4-3-303(a)(3)), X's note is issued for value. Under subsection (b) (A.C.A. § 4-3-303(b)), the note is also issued for consideration whether or not, under contract law, Y is deemed to have given consideration for the note.

*Case #2.* X issues a check to Y in consideration of Y's promise to perform services in the future. Although the executory promise is consideration for issuance of the check it is value only to the extent the promise is performed. Subsection (a)(1) (A.C.A. § 4-3-303(a)(1)).

*Case #3.* X issues a note to Y in consideration of Y's promise to perform services. If at the due date of the note Y's performance is not yet due, Y may enforce the note because it was issued for consideration. But if at the due date of the note, Y's performance is due and has not been performed, X has a defense. Subsection (b) (A.C.A. § 4-3-303(b)).

2. Subsection (a) (A.C.A. § 4-3-303(a)), which defines value, has primary importance in cases in which the issue is whether the holder of an instrument is a holder in due course and particularly to cases in which the issuer of the instrument has a defense to the instrument. Suppose Buyer and Seller signed a contract on April 1 for the sale of goods to be delivered on May 1. Payment of 50% of the price of the goods was due upon signing of the contract. On April 1 Buyer delivered to Seller a check in the amount due under the contract. The check was drawn by X to Buyer as payee and was indorsed to Seller. When the check was presented for payment to the drawee on April 2, it was dishonored because X had stopped payment. At that time Seller had not taken any action to perform the contract with Buyer. If X has a defense on the check, the defense can be asserted against Seller who is not a holder in due course because Seller did not give value for the check. Subsection (a)(1) (A.C.A. § 4-3-303(a)(1)).

The policy basis for subsection (a)(1) (A.C.A. § 4-3-303(a)(1)) is that the holder who gives an executory promise of performance will not suffer an out-of-pocket loss to the extent the executory promise is unperformed at the time the holder learns of dishonor of the instrument. When Seller took delivery of the check on April 1, Buyer's obligation to pay 50% of the price on that date was suspended, but when the check was dishonored on April 2 the obligation revived. Section 3-310(b) (A.C.A. § 4-3-310(b)). If payment for goods is due at or before delivery and the Buyer fails to make the payment, the Seller is excused from performing the promise to deliver the goods. Section 2-703 (A.C.A. § 4-2-703). Thus, Seller is protected from an out-of-pocket loss even if the check is not enforceable. Holder-in-due-course status is not necessary to protect Seller.

3. Subsection (a)(2) (A.C.A. § 4-3-303(a)(2)) equates value with the obtaining of a security interest or a nonjudicial lien in the instrument. The term "security interest" covers Article 9 (A.C.A. § 4-9-101 et seq.) cases in which an instrument is taken as collateral as well as bank collection cases in which a bank acquires a security interest under Section 4-210 (A.C.A. § 4-4-210). The acquisition of a common-law or statutory banker's lien is also value under subsection (a)(2) (A.C.A. § 4-3-303(a)(2)). An attaching creditor or other person who acquires a lien by judicial proceedings does not give value for the purposes of subsection (a)(2) (A.C.A. § 4-3-303(a)(2)).

4. Subsection (a)(3) (A.C.A. § 4-3-303(a)(3)) follows former Section 3-303(b) in providing that the holder takes for value if the instrument is taken in payment of or as security for an antecedent claim, even though there is no extension of time or other concession, and whether or not the claim is due. Subsection (a)(3) (A.C.A. § 4-3-303(a)(3)) applies to any claim against any person; there is no requirement that the claim arise out of contract. In particular the provision is intended to apply to an instrument given in payment of or as security for the debt of a third person, even though no concession is made in return.

5. Subsection (a)(4) and (5) (A.C.A. § 4-3-303(a)(4) and (5)) restate former Section 3-303(c). They state generally recognized



exceptions to the rule that an executory promise is not value. A negotiable instrument is value because it carries the possibility of negotiation to a holder in due course, after which the party who gives it

is obliged to pay. The same reasoning applies to any irrevocable commitment to a third person, such as a letter of credit issued when an instrument is taken.

### Comment to § 3-304 (A.C.A. § 4-3-304)

1. To be a holder in due course, one must take without notice that an instrument is overdue. Section 3-302(a)(2)(iii) (A.C.A. § 4-3-302(a)(2)(iii)). Section 3-304 (A.C.A. § 4-3-304) replaces subsection (3) of former Section 3-304. For the sake of clarity it treats demand and time instruments separately. Subsection (a) (A.C.A. § 4-3-304(a)) applies to demand instruments. A check becomes stale after 90 days.

Under former Section 3-304(3)(c), a holder that took a demand note had notice that it was overdue if it was taken "more than a reasonable length time after its issue." In substitution for this test, subsection (a)(3) (A.C.A. § 4-3-304(a)(3)) re-

quires the trier of fact to look at both the circumstances of the particular case and the nature of the instrument and trade usage. Whether a demand note is stale may vary a great deal depending on the facts of the particular case.

2. Subsections (b) and (c) (A.C.A. § 4-3-304(b) and (c)) cover time instruments. They follow the distinction made under former Article 3 (A.C.A. § 4-3-101 et seq.) between defaults in payment of principal and interest. In subsection (b) (A.C.A. § 4-3-304(b)) installment instruments and single payment instruments are treated separately. If an installment is late, the instrument is overdue until the default is cured.

### Comment to § 3-305 (A.C.A. § 4-3-305)

1. Subsection (a) (A.C.A. § 4-3-305(a)) states the defenses to the obligation of a party to pay the instrument. Subsection (a)(1) (A.C.A. § 4-3-305(a)(1)) states the "real defenses" that may be asserted against any person entitled to enforce the instrument.

Subsection (a)(1)(i) (A.C.A. § 4-3-305(a)(1)(i)) allows assertion of the defense of infancy against a holder in due course, even though the effect of the defense is to render the instrument voidable but not void. The policy is one of protection of the infant even at the expense of occasional loss to an innocent purchaser. No attempt is made to state when infancy is available as a defense or the conditions under which it may be asserted. In some jurisdictions it is held that an infant cannot rescind the transaction or set up the defense unless the holder is restored to the position held before the instrument was taken which, in the case of a holder in due course, is normally impossible. In other states an infant who has misrepresented age may be estopped to assert infancy. Such questions are left to other law, as an integral part of the policy of each state as to the protection of infants.

Subsection (a)(1)(ii) (A.C.A. § 4-3-305(a)(1)(ii)) covers mental incompetence, guardianship, *ultra vires* acts or lack of corporate capacity to do business, or any other incapacity apart from infancy. Such incapacity is largely statutory. Its existence and effect is left to the law of each state. If under the state law the effect is to render the obligation of the instrument entirely null and void, the defense may be asserted against a holder in due course. If the effect is merely to render the obligation voidable at the election of the obligor, the defense is cut off.

Duress, which is also covered by subsection (a)(ii) (A.C.A. § 4-3-305(a)(ii)), is a matter of degree. An instrument signed at the point of a gun is void, even in the hands of a holder in due course. One signed under threat to prosecute the son of the maker for theft may be merely voidable, so that the defense is cut off. Illegality is most frequently a matter of gambling or usury, but may arise in other forms under a variety of statutes. The statutes differ in their provisions and the interpretations given them. They are primarily a matter of local concern and local policy. All such matters are therefore left

to the local law. If under that law the effect of the duress or the illegality is to make the obligation entirely null and void, the defense may be asserted against a holder in due course. Otherwise it is cut off.

Subsection (a)(1)(iii) (A.C.A. § 4-3-305(a)(1)(iii)) refers to "real" or "essential" fraud, sometimes called fraud in the essence or fraud in the factum, as effective against a holder in due course. The common illustration is that of the maker who is tricked into signing a note in the belief that it is merely a receipt or some other document. The theory of the defense is that the signature on the instrument is ineffective because the signer did not intend to sign such an instrument at all. Under this provision the defense extends to an instrument signed with knowledge that it is a negotiable instrument, but without knowledge of its essential terms. The test of the defense is that of excusable ignorance of the contents of the writing signed. The party must not only have been in ignorance, but must also have had no reasonable opportunity to obtain knowledge. In determining what is a reasonable opportunity all relevant factors are to be taken into account, including the intelligence, education, business experience, and ability to read or understand English of the signer. Also relevant is the nature of the representations that were made, whether the signer had good reason to rely on the representations or to have confidence in the person making them, the presence or absence of any third person who might read or explain the instrument to the signer, or any other possibility of obtaining independent information, and the apparent necessity, or lack of it, for acting without delay. Unless the misrepresentation meets this test, the defense is cut off by a holder in due course.

Subsection (a)(1)(iv) (A.C.A. § 4-3-305(a)(1)(iv)) states specifically that the defense of discharge in insolvency proceedings is not cut off when the instrument is purchased by a holder in due course. "Insolvency proceedings" is defined in Section 1-201(22) (A.C.A. § 4-1-201(22)) and it includes bankruptcy whether or not the debtor is insolvent. Subsection (2)(e) of former Section 3-305 is omitted. The substance of that provision is stated in Section 3-601(b) (A.C.A. § 4-3-601(b)).

2. Subsection (a)(2) (A.C.A. § 4-3-305(a)(2)) states other defenses that, pursuant to subsection (b) (A.C.A. § 4-3-305(b)), are cut off by a holder in due course. These defenses comprise those specifically stated in Article 3 (A.C.A. § 4-3-101 et seq.) and those based on common law contract principles. Article 3 (A.C.A. § 4-3-101 et seq.) defenses are nonissuance of the instrument, conditional issuance, and issuance for a special purpose (Section 3-105(b)) (A.C.A. § 4-3-105(b)); failure to countersign a traveler's check (Section 3-106(c)) (A.C.A. § 4-3-106(c)); modification of the obligation by a separate agreement (Section 3-117) (A.C.A. § 4-3-117); payment that violates a restrictive indorsement (Section 3-206(f)) (A.C.A. § 4-3-206(f)); instruments issued without consideration or for which promised performance has not been given (Section 3-303(b)) (A.C.A. § 4-3-303(b)), and breach of warranty when a draft is accepted (Section 3-417(b)) (A.C.A. § 4-3-417(b)). The most prevalent common law defenses are fraud, misrepresentation or mistake in the issuance of the instrument. In most cases the holder in due course will be an immediate or remote transferee of the payee of the instrument. In most cases the holder-in-due-course doctrine is irrelevant if defenses are being asserted against the payee of the instrument, but in a small number of cases the payee of the instrument may be a holder in due course. Those cases are discussed in Comment 4 to Section 3-302 (A.C.A. § 4-3-302).

Assume Buyer issues a note to Seller in payment of the price of goods that Seller fraudulently promises to deliver but which are never delivered. Seller negotiates the note to Holder who has no notice of the fraud. If Holder is a holder in due course, Holder is not subject to Buyer's defense of fraud. But in some cases an original party to the instrument is a holder in due course. For example, Buyer fraudulently induces Bank to issue a cashier's check to the order of Seller. The check is delivered by Bank to Seller, who has no notice of the fraud. Seller can be a holder in due course and can take the check free of Bank's defense of fraud. This case is discussed as Case # 1 in Comment 4 to Section 3-302 (A.C.A. § 4-3-302). Former Section 3-305 stated that a holder in due course takes free of defenses of "any party



to the instrument with whom the holder has not dealt." The meaning of this language was not at all clear and if read literally could have produced the wrong result. In the hypothetical case, it could be argued that Seller "dealt" with Bank because Bank delivered the check to Seller. But it is clear that Seller should take free of Bank's defense against Buyer regardless of whether Seller took delivery of the check from Buyer or from Bank. The quoted language is not included in Section 3-305 (A.C.A. § 4-3-305). It is not necessary. If Buyer issues an instrument to Seller and Buyer has a defense against Seller, that defense can obviously be asserted. Buyer and Seller are the only people involved. The holder-in-due-course doctrine has no relevance. The doctrine applies only to cases in which more than two parties are involved. Its essence is that the holder in due course does not have to suffer the consequences of a defense of the obligor on the instrument that arose from an occurrence with a third party.

3. Subsection (a)(3) (A.C.A. § 4-3-305(a)(3)) is concerned with claims in recoupment which can be illustrated by the following example. Buyer issues a note to the order of Seller in exchange for a promise of Seller to deliver specified equipment. If Seller fails to deliver the equipment or delivers equipment that is rightfully rejected, Buyer has a defense to the note because the performance that was the consideration for the note was not rendered. Section 3-303(b) (A.C.A. § 4-3-303(b)). This defense is included in Section 3-305(a)(2) (A.C.A. § 4-3-305(a)(2)). That defense can always be asserted against Seller. This result is the same as that reached under former Section 3-408.

But suppose Seller delivered the promised equipment and it was accepted by Buyer. The equipment, however, was defective. Buyer retained the equipment and incurred expenses with respect to its repair. In this case, Buyer does not have a defense under Section 3-303(b) (A.C.A. § 4-3-303(b)). Seller delivered the equipment and the equipment was accepted. Under Article 2 (A.C.A. § 4-2-101 et seq.), Buyer is obliged to pay the price of the equipment which is represented by the note. But Buyer may have a claim against Seller for breach of warranty. If Buyer has a warranty claim, the claim may be as-

serted against Seller as a counterclaim or as a claim in recoupment to reduce the amount owing on the note. It is not relevant whether Seller is or is not a holder in due course of the note or whether Seller knew or had notice that Buyer had the warranty claim. It is obvious that holder-in-due-course doctrine cannot be used to allow Seller to cut off a warranty claim that Buyer has against Seller. Subsection (b) (A.C.A. § 4-3-305(b)) specifically covers this point by stating that a holder in due course is not subject to a "claim in recoupment ... against a person other than the holder."

Suppose Seller negotiates the note to Holder. If Holder had notice of Buyer's warranty claim at the time the note was negotiated to Holder, Holder is not a holder in due course (Section 3-302(a)(2)(iv)) (A.C.A. § 4-3-302(a)(2)(iv)) and Buyer may assert the claim against Holder (Section 3-305(a)(3)) (A.C.A. § 4-3-305(a)(3)) but only as a claim in recoupment, i.e. to reduce the amount owed on the note. If the warranty claim is \$1,000 and the unpaid note is \$10,000, Buyer owes \$9,000 to Holder. If the warranty claim is more than the unpaid amount of the note, Buyer owes nothing to Holder, but Buyer cannot recover the unpaid amount of the warranty claim from Holder. If Buyer had already partially paid the note, Buyer is not entitled to recover the amounts paid. The claim can be used only as an offset to amounts owing on the note. If Holder had no notice of Buyer's claim and otherwise qualifies as a holder in due course, Buyer may not assert the claim against Holder. Section 3-305(b) (A.C.A. § 4-3-305(b)).

The result under Section 3-305 (A.C.A. § 4-3-305) is consistent with the result reached under former Article 3, but the rules for reaching the result are stated differently. Under former Article 3 Buyer could assert rights against Holder only if Holder was not a holder in due course, and Holder's status depended upon whether Holder had notice of a defense by Buyer. Courts have held that Holder had that notice if Holder had notice of Buyer's warranty claim. The rationale under former Article 3 was "failure of consideration." This rationale does not distinguish between cases in which the seller fails to perform and those in which the buyer accepts the performance of seller but

makes a claim against the seller because the performance is faulty. The term "failure of consideration" is subject to varying interpretations and is not used in Article 3 (A.C.A. § 4-3-101 et seq.). The use of the term "claim in recoupment" in Section 3-305(a)(3) (A.C.A. § 4-3-305(a)(3)) is a more precise statement of the nature of Buyer's right against Holder. The use of the term does not change the law because the treatment of a defense under subsection (a)(2) (A.C.A. § 4-3-305(a)(2)) and a claim in recoupment under subsection (a)(3) (A.C.A. § 4-3-305(a)(3)) is essentially the same.

Under former Article 3, case law was divided on the issue of the extent to which an obligor on a note could assert against a transferee who is not a holder in due course a debt or other claim that the obligor had against the original payee of the instrument. Some courts limited claims to those that arose in the transaction that gave rise to the note. This is the approach taken in Section 3-305(a)(3) (A.C.A. § 4-3-305(a)(3)). Other courts allowed the obligor on the note to use any debt or other claim, no matter how unrelated to the note, to offset the amount owed on the note. Under current judicial authority and non-UCC statutory law, there will be many cases in which a transferee of a note arising from a sale transaction will not qualify as a holder in due course. For example, applicable law may require the use of a note to which there cannot be a holder in due course. See Section 3-106(d) (A.C.A. § 4-3-106(d)) and Comment 3 to Section 3-106 (A.C.A. § 4-3-106). It is reasonable to provide that the buyer should not be denied the right to assert claims arising out of the sale transaction. Subsection (a)(3) (A.C.A. § 4-3-305(a)(3)) is based on the belief that it is not reasonable to require the transferee to bear the risk that wholly unrelated claims may also be asserted. The determination of whether a claim arose from the transaction that gave rise to the instrument is determined by law other than this Article (Chapter) (A.C.A. § 4-3-101 et seq.) and thus may vary as local law varies.

4. Subsection (c) (A.C.A. § 4-3-305(c)) concerns claims and defenses of a person other than the obligor on the instrument. It applies principally to cases in which an obligation is paid with the instrument of a third person. For example, Buyer buys

goods from Seller and negotiates to Seller a cashier's check issued by Bank in payment of the price. Shortly after delivering the check to Seller, Buyer learns that Seller had defrauded Buyer in the sale transaction. Seller may enforce the check against Bank even though Seller is not a holder in due course. Bank has no defense to its obligation to pay the check and it may not assert defenses, claims in recoupment, or claims to the instrument of Buyer, except to the extent permitted by the but clause of the first sentence of subsection (c) (A.C.A. § 4-3-305(c)). Buyer may have a claim to the instrument under Section 3-306 (A.C.A. § 4-3-306) based on a right to rescind the negotiation to Seller because of Seller's fraud. Section 3-202(b) (A.C.A. § 4-3-202(b)) and Comment 2 to Section 3-201 (A.C.A. § 4-3-201). Bank cannot assert that claim unless Buyer is joined in the action in which Seller is trying to enforce payment of the check. In that case Bank may pay the amount of the check into court and the court will decide whether that amount belongs to Buyer or Seller. The last sentence of subsection (c) (A.C.A. § 4-3-305(c)) allows the issuer of an instrument such as a cashier's check to refuse payment in the rare case in which the issuer can prove that the instrument is a lost or stolen instrument and the person seeking enforcement does not have rights of a holder in due course.

5. Subsection (d) (A.C.A. § 4-3-305(d)) applies to instruments signed for accommodation (Section 3-419) (A.C.A. § 4-3-419) and this subsection equates the obligation of the accommodation party to that of the accommodated party. The accommodation party can assert whatever defense or claim the accommodated party had against the person enforcing the instrument. The only exceptions are discharge in bankruptcy, infancy and lack of capacity. The same rule does not apply to an indorsement by a holder of the instrument in negotiating the instrument. The indorser, as transferor, makes a warranty to the indorsee, as transferee, that no defense or claim in recoupment is good against the indorser. Section 3-416(a)(4) (A.C.A. § 4-3-416(a)(4)). Thus, if the indorsee sues the indorser because of dishonor of the instrument, the indorser may not assert the defense or claim in recoupment of the maker or drawer against the indorsee.



**Comment to § 3-306 (A.C.A. § 4-3-306)**

This section (A.C.A. § 4-3-306) expands on the reference to “claims to” the instrument mentioned in former Sections 3-305 and 3-306. Claims covered by the section (A.C.A. § 4-3-306) include not only claims to ownership but also any other claim of a property or possessory right. It includes the claim to a lien or the claim of a person in rightful possession of an instrument

who was wrongfully deprived of possession. Also included is a claim based on Section 3-202(b) (A.C.A. § 4-3-202(b)) for rescission of a negotiation of the instrument by the claimant. Claims to an instrument under Section 3-306 (A.C.A. § 4-3-306) are different from claims in recoupment referred to in Section 3-305(a)(3) (A.C.A. § 4-3-305(a)(3)).

**Comment to § 3-307 (A.C.A. § 4-3-307)**

1. This section (A.C.A. § 4-3-307) states rules for determining when a person who has taken an instrument from a fiduciary has notice of a breach of fiduciary duty that occurs as a result of the transaction with the fiduciary. Former Section 3-304(2) and (4)(e) related to this issue, but those provisions were unclear in their meaning. Section 3-307 (A.C.A. § 4-3-307) is intended to clarify the law by stating rules that comprehensively cover the issue of when the taker of an instrument has notice of breach of a fiduciary duty and thus notice of a claim to the instrument or its proceeds.

2. Subsection (a) (A.C.A. § 4-3-307(a)) defines the terms “fiduciary” and “represented person” and the introductory paragraph of subsection (b) (A.C.A. § 4-3-307(b)) describes the transaction to which the section applies. The basic scenario is one in which the fiduciary in effect embezzles money of the represented person by applying the proceeds of an instrument that belongs to the represented person to the personal use of the fiduciary. The person dealing with the fiduciary may be a depository bank that takes the instrument for collection or a bank or other person that pays value for the instrument. The section also covers a transaction in which an instrument is presented for payment to a payor bank that pays the instrument by giving value to the fiduciary. Subsections (b)(2), (3), and (4) (A.C.A. § 4-3-307(b)(2)-(4)) state rules for determining when the person dealing with the fiduciary has notice of breach of fiduciary duty. Subsection (b)(1) (A.C.A. § 4-3-307(b)(1)) states that notice of breach of fiduciary duty is notice of the represented person's claim to the instrument or its proceeds.

Under Section 3-306 (A.C.A. § 4-3-306), a person taking an instrument is subject to a claim to the instrument or its proceeds, unless the taker has rights of a holder in due course. Under Section 3-302(a)(2)(v) (A.C.A. § 4-3-302(a)(2)(v)), the taker cannot be a holder in due course if the instrument was taken with notice of a claim under Section 3-306 (A.C.A. § 4-3-306). Section 3-307 (A.C.A. § 4-3-307) applies to cases in which a represented person is asserting a claim because a breach of fiduciary duty resulted in a misapplication of the proceeds of an instrument. The claim of the represented person is a claim described in Section 3-306 (A.C.A. § 4-3-306). Section 3-307 (A.C.A. § 4-3-307) states rules for determining when a person taking an instrument has notice of the claim which will prevent assertion of rights as a holder in due course. It also states rules for determining when a payor bank pays an instrument with notice of breach of fiduciary duty.

Section 3-307(b) (A.C.A. § 4-3-307(b)) applies only if the person dealing with the fiduciary “has knowledge of the fiduciary status of the fiduciary.” Notice which does not amount to knowledge is not enough to cause Section 3-307 (A.C.A. § 4-3-307) to apply. “Knowledge” is defined in Section 1-201(25) (A.C.A. § 4-1-201(25)). In most cases, the “taker” referred to in Section 3-307 (A.C.A. § 4-3-307) will be a bank or other organization. Knowledge of an organization is determined by the rules stated in Section 1-201(27) (A.C.A. § 4-1-201(27)). In many cases, the individual who receives and processes an instrument on behalf of the organization that is the taker of the instrument “for payment or collection or for value” is a clerk who has

no knowledge of any fiduciary status of the person from whom the instrument is received. In such cases, Section 3-307 (A.C.A. § 4-3-307) doesn't apply because, under Section 1-201(27) (A.C.A. § 4-1-201(27)), knowledge of the organization is determined by the knowledge of the "individual conducting that transaction," i.e. the clerk who receives and processes the instrument. Furthermore, paragraphs (2) and (4) (A.C.A. § 4-3-307(b)(2) and (4)) each require that the person acting for the organization have knowledge of facts that indicate a breach of fiduciary duty. In the case of an instrument taken for deposit to an account, the knowledge is found in the fact that the deposit is made to an account other than that of the represented person or a fiduciary account for benefit of that person. In other cases the person acting for the organization must know that the instrument is taken in payment or as security for a personal debt of the fiduciary or for the personal benefit of the fiduciary. For example, if the instrument is being used to buy goods or services, the person acting for the organization must know that the goods or services are for the personal benefit of the fiduciary. The requirement that the taker have knowledge rather than notice is meant to limit Section 3-307 (A.C.A. § 4-3-307) to relatively uncommon cases in which the person who deals with the fiduciary knows all the relevant facts: the fiduciary status and that the proceeds of the instrument are being used for the personal debt or benefit of the fiduciary or are being paid to an account that is not an account of the represented person or of the fiduciary, as such. Mere notice of these facts is not enough to put the taker on notice of the breach of fiduciary duty and does not give rise to any duty of investigation by the taker.

3. Subsection (b)(2) (A.C.A. § 4-3-307(b)(2)) applies to instruments payable to the represented person or the fiduciary as such. For example, a check payable to Corporation is indorsed in the name of Corporation by Doe as its President. Doe gives the check to Bank as partial repayment of a personal loan that Bank had made to Doe. The check was indorsed either in blank or to Bank. Bank collects the check and applies the proceeds to reduce the amount owed on Doe's loan. If the person acting for Bank in the transac-

tion knows that Doe is a fiduciary and that the check is being used to pay a personal obligation of Doe, subsection (b)(2) (A.C.A. § 4-3-307(b)(2)) applies. If Corporation has a claim to the proceeds of the check because the use of the check by Doe was a breach of fiduciary duty, Bank has notice of the claim and did not take the check as a holder in due course. The same result follows if Doe had indorsed the check to himself before giving it to Bank. Subsection (b)(2) (A.C.A. § 4-3-307(b)(2)) follows Uniform Fiduciaries Act § 4 in providing that if the instrument is payable to the fiduciary, as such, or to the represented person, the taker has notice of a claim if the instrument is negotiated for the fiduciary's personal debt. If fiduciary funds are deposited to a personal account of the fiduciary or to an account that is not an account of the represented person or of the fiduciary, as such, there is a split of authority concerning whether the bank is on notice of a breach of fiduciary duty. Subsection (b)(2)(iii) (A.C.A. § 4-3-307(b)(2)(iii)) states that the bank is given notice of breach of fiduciary duty because of the deposit. The Uniform Fiduciaries Act § 9 states that the bank is not on notice unless it has knowledge of facts that makes its receipt of the deposit an act of bad faith.

The rationale of subsection (b)(2) (A.C.A. § 4-3-307(b)(2)) is that it is not normal for an instrument payable to the represented person or the fiduciary, as such, to be used for the personal benefit of the fiduciary. It is likely that such use reflects an unlawful use of the proceeds of the instrument. If the fiduciary is entitled to compensation from the represented person for services rendered or for expenses incurred by the fiduciary the normal mode of payment is by a check drawn on the fiduciary account to the order of the fiduciary.

4. Subsection (b)(3) (A.C.A. § 4-3-307(b)(3)) is based on Uniform Fiduciaries Act § 6 and applies when the instrument is drawn by the represented person or the fiduciary as such to the fiduciary personally. The term "personally" is used as it is used in the Uniform Fiduciaries Act to mean that the instrument is payable to the payee as an individual and not as a fiduciary. For example, Doe as President of Corporation writes a check on Corporation's account to the order of Doe person-



ally. The check is then indorsed over to Bank as in Comment 3. In this case there is no notice of breach of fiduciary duty because there is nothing unusual about the transaction. Corporation may have owed Doe money for salary, reimbursement for expenses incurred for the benefit of Corporation, or for any other reason. If Doe is authorized to write checks on behalf of Corporation to pay debts of Corporation, the check is a normal way of paying a debt owed to Doe. Bank may assume that Doe may use the instrument for his personal benefit.

5. Subsection (b)(4) (A.C.A. § 4-3-307(b)(4)) can be illustrated by a hypothetical case. Corporation draws a check payable to an organization. X, an officer or employee of Corporation, delivers the check to a person acting for the organization. The person signing the check on behalf of Corporation is X or another person. If the person acting for the organization in the transaction knows that X is a

fiduciary, the organization is on notice of a claim by Corporation if it takes the instrument under the same circumstances stated in subsection (b)(2) (A.C.A. § 4-3-307(b)(2)). If the organization is a bank and the check is taken in repayment of a personal loan of the bank to X, the case is like the case discussed in Comment 3. It is unusual for Corporation, the represented person, to pay a personal debt of Doe by issuing a check to the bank. It is more likely that the use of the check by Doe reflects an unlawful use of the proceeds of the check. The same analysis applies if the check is made payable to an organization in payment of goods or services. If the person acting for the organization knew of the fiduciary status of X and that the goods or services were for X's personal benefit, the organization is on notice of a claim by Corporation to the proceeds of the check. See the discussion in the last paragraph of Comment 2.

### Comment to § 3-308 (A.C.A. § 4-3-308)

1. Section 3-308 (A.C.A. § 4-3-308) is a modification of former Section 3-307. The first two sentences of subsection (a) (A.C.A. § 4-3-308(a)) are a restatement of former Section 3-307(1). The purpose of the requirement of a specific denial in the pleadings is to give the plaintiff notice of the defendant's claim of forgery or lack of authority as to the particular signature, and to afford the plaintiff an opportunity to investigate and obtain evidence. If local rules of pleading permit, the denial may be on information and belief, or it may be a denial of knowledge or information sufficient to form a belief. It need not be under oath unless the local statutes or rules require verification. In the absence of such specific denial the signature stands admitted, and is not in issue. Nothing in this section (A.C.A. § 4-3-308) is intended, however, to prevent amendment of the pleading in a proper case.

The question of the burden of establishing the signature arises only when it has been put in issue by specific denial. "Burden of establishing" is defined in Section 1-201 (A.C.A. § 4-1-201). The burden is on the party claiming under the signature, but the signature is presumed to be authentic and authorized except as stated in

the second sentence of subsection (a) (A.C.A. § 4-3-308(a)). "Presumed" is defined in Section 1-201 (A.C.A. § 4-1-201) and means that until some evidence is introduced which would support a finding that the signature is forged or unauthorized, the plaintiff is not required to prove that it is valid. The presumption rests upon the fact that in ordinary experience forged or unauthorized signatures are very uncommon, and normally any evidence is within the control of, or more accessible to, the defendant. The defendant is therefore required to make some sufficient showing of the grounds for the denial before the plaintiff is required to introduce evidence. The defendant's evidence need not be sufficient to require a directed verdict, but it must be enough to support the denial by permitting a finding in the defendant's favor. Until introduction of such evidence the presumption requires a finding for the plaintiff. Once such evidence is introduced the burden of establishing the signature by a preponderance of the total evidence is on the plaintiff. The presumption does not arise if the action is to enforce the obligation of a purported signer who has died or become incompetent before the evidence is re-

quired, and so is disabled from obtaining or introducing it. "Action" is defined in Section 1-201 (A.C.A. § 4-1-201) and includes a claim asserted against the estate of a deceased or an incompetent.

The last sentence of subsection (a) (A.C.A. § 4-3-308(a)) is a new provision that is necessary to take into account Section 3-402(a) (A.C.A. § 4-3-402(a)) that allows an undisclosed principal to be liable on an instrument signed by an authorized representative. In that case the person enforcing the instrument must prove that the undisclosed principal is liable.

2. Subsection (b) (A.C.A. § 4-3-308(b)) restates former Section 3-307(2) and (3). Once signatures are proved or admitted a holder, by mere production of the instrument, proves "entitlement to enforce the instrument" because under Section 3-301 (A.C.A. § 4-3-301) a holder is a person entitled to enforce the instrument. Any other person in possession of an instrument may recover only if that person has the rights of a holder. Section 3-301 (A.C.A. § 4-3-301). That person must prove a transfer giving that person such rights under Section 3-203(b) (A.C.A. § 4-3-203(b)) or that such rights were obtained by subrogation or succession.

If a plaintiff producing the instrument proves entitlement to enforce the instrument, either as a holder or a person with rights of a holder, the plaintiff is entitled to recovery unless the defendant proves a defense or claim in recoupment. Until

proof of a defense or claim in recoupment is made, the issue as to whether the plaintiff has rights of a holder in due course does not arise. In the absence of a defense or claim in recoupment, any person entitled to enforce the instrument is entitled to recover. If a defense or claim in recoupment is proved, the plaintiff may seek to cut off the defense or claim in recoupment by proving that the plaintiff is a holder in due course or that the plaintiff has rights of a holder in due course under Section 3-203(b) (A.C.A. § 4-3-203(b)) or by subrogation or succession. All elements of Section 3-302(a) (A.C.A. § 4-3-302(a)) must be proved.

Nothing in this section (A.C.A. § 4-3-308) is intended to say that the plaintiff must necessarily prove rights as a holder in due course. The plaintiff may elect to introduce no further evidence, in which case a verdict may be directed for the plaintiff or the defendant, or the issue of the defense or claim in recoupment may be left to the trier of fact, according to the weight and sufficiency of the defendant's evidence. The plaintiff may elect to rebut the defense or claim in recoupment by proof to the contrary, in which case a verdict may be directed for either party or the issue may be for the trier of fact. Subsection (b) (A.C.A. § 4-3-308(b)) means only that if the plaintiff claims the rights of a holder in due course against the defense or claim in recoupment, the plaintiff has the burden of proof on that issue.

### Comment to § 3-309 (A.C.A. § 4-3-309)

Section 3-309 (A.C.A. § 4-3-309) is a modification of former Section 3-804. The rights stated are those of "a person entitled to enforce the instrument" at the time of loss rather than those of an "owner" as in former Section 3-804. Under subsection (b) (A.C.A. § 4-3-309(b)), judgment to enforce the instrument cannot be given unless the court finds that the defendant will be adequately protected against a claim to the instrument by a holder that may appear at some later time. The court is given discretion in determining how adequate protection is to be assured. Former Section 3-804 allowed the court to "require security indemnifying the defendant against loss." Under Section 3-309 (A.C.A.

§ 4-3-309) adequate protection is a flexible concept. For example, there is substantial risk that a holder in due course may make a demand for payment if the instrument was payable to bearer when it was lost or stolen. On the other hand if the instrument was payable to the person who lost the instrument and that person did not indorse the instrument, no other person could be a holder of the instrument. In some cases there is risk of loss only if there is doubt about whether the facts alleged by the person who lost the instrument are true. Thus, the type of adequate protection that is reasonable in the circumstances may depend on the degree of certainty about the facts in the case.



**Comment to § 3-310 (A.C.A. § 4-3-310)**

1. Section 3-310 (A.C.A. § 4-3-310) is a modification of former Section 3-802. As a practical matter, application of former Section 3-802 was limited to cases in which a check or a note was given for an obligation. Subsections (a) and (b) of Section 3-310 (A.C.A. § 4-3-310(a) and (b)) are therefore stated in terms of checks and notes in the interests of clarity. Subsection (c) (A.C.A. § 4-3-310(c)) covers the rare cases in which some other instrument is given to pay an obligation.

2. Subsection (a) (A.C.A. § 4-3-310(a)) deals with the case in which a certified check, cashier's check, or teller's check is given in payment of an obligation. In that case the obligation is discharged unless there is an agreement to the contrary. Subsection (a) (A.C.A. § 4-3-310(a)) drops the exception in former Section 3-802 for cases in which there is a right of recourse on the instrument against the obligor. Under former Section 3-802(1)(a) the obligation was not discharged if there was a right of recourse on the instrument against the obligor. Subsection (a) (A.C.A. § 4-3-310(a)) changes this result. The underlying obligation is discharged, but any right of recourse on the instrument is preserved.

3. Subsection (b) (A.C.A. § 4-3-310(b)) concerns cases in which an uncertified check or a note is taken for an obligation. The typical case is that in which a buyer pays for goods or services by giving the seller the buyer's personal check, or in which the buyer signs a note for the purchase price. Subsection (b) (A.C.A. § 4-3-310(b)) also applies to the uncommon cases in which a check or note of a third person is given in payment of the obligation. Subsection (b) (A.C.A. § 4-3-310(b)) preserves the rule under former Section 3-802(1)(b) that the buyer's obligation to pay the price is suspended, but subsection (b) (A.C.A. § 4-3-310(b)) spells out the effect more precisely. If the check or note is dishonored, the seller may sue on either the dishonored instrument or the contract of sale if the seller has possession of the instrument and is the person entitled to enforce it. If the right to enforce the instrument is held by somebody other than the seller, the seller can't enforce the right to payment of the price under the sales

contract because that right is represented by the instrument which is enforceable by somebody else. Thus, if the seller sold the note or the check to a holder and has not reacquired it after dishonor, the only right that survives is the right to enforce the instrument.

The last sentence of subsection (b)(3) (A.C.A. § 4-3-310(b)(3)) applies to cases in which an instrument of another person is indorsed over to the obligee in payment of the obligation. For example, Buyer delivers an uncertified personal check of X payable to the order of Buyer to Seller in payment of the price of goods. Buyer indorses the check over to Seller. Buyer is liable on the check as indorser. If Seller neglects to present the check for payment or deposit it for collection within 30 days of the indorsement, Buyer's liability as indorser is discharged. Section 3-415(e) (A.C.A. § 4-3-415(e)). Under the last sentence of Section 3-310(b)(3) (A.C.A. § 4-3-310(b)(3)) Buyer is also discharged on the obligation to pay for the goods.

4. There was uncertainty concerning the applicability of former Section 3-802 to the case in which the check given for the obligation was stolen from the payee, the payee's signature was forged, and the forger obtained payment. The last sentence of subsection (b)(4) (A.C.A. § 4-3-310(b)(4)) addresses this issue. If the payor bank pays a holder, the drawer is discharged on the underlying obligation because the check was paid. Subsection (b)(1) (A.C.A. § 4-3-310(b)(1)). If the payor bank pays a person not entitled to enforce the instrument, as in the hypothetical case, the suspension of the underlying obligation continues because the check has not been paid. Section 3-602(a) (A.C.A. § 4-3-602(a)). The payee's cause of action is against the depository bank or payor bank in conversion under Section 3-420 (A.C.A. § 4-3-420) or against the drawer under Section 3-309 (A.C.A. § 4-3-309). In the latter case, the drawer's obligation under Section 3-414(b) (A.C.A. § 4-3-414(b)) is triggered by dishonor which occurs because the check is unpaid. Presentment for payment to the drawee is excused under Section 3-504(a)(i) (A.C.A. § 4-3-504(a)(i)) and, under Section 3-502(e) (A.C.A. § 4-3-502(e)), dishonor

occurs without presentment if the check is not paid. The payee cannot merely ignore the instrument and sue the drawer on the underlying contract. This would impose on the drawer the risk that the check when stolen was indorsed in blank or to bearer.

A similar analysis applies with respect to lost instruments that have not been paid. If a creditor takes a check of the debtor in payment of an obligation, the obligation is suspended under the introductory paragraph of subsection (b) (A.C.A. § 4-3-310(b)). If the creditor then loses the check, what are the creditor's rights? The creditor can request the debtor to issue a new check and in many cases, the debtor will issue a replacement check after stopping payment on the lost check. In that case both the debtor and

creditor are protected. But the debtor is not obliged to issue a new check. If the debtor refuses to issue a replacement check, the last sentence of subsection (b)(4) (A.C.A. § 4-3-310(b)(4)) applies. The creditor may not enforce the obligation of debtor for which the check was taken. The creditor may assert only rights on the check. The creditor can proceed under Section 3-309 (A.C.A. § 4-3-309) to enforce the obligation of the debtor, as drawer, to pay the check.

5. Subsection (c) (A.C.A. § 4-3-310(c)) deals with rare cases in which other instruments are taken for obligations. If a bank is the obligor on the instrument, subsection (a) (A.C.A. § 4-3-310(a)) applies and the obligation is discharged. In any other case subsection (b) (A.C.A. § 4-3-310(b)) applies.

### Comment to § 3-311 (A.C.A. § 4-3-311)

1. This section (A.C.A. § 4-3-311) deals with an informal method of dispute resolution carried out by use of a negotiable instrument. In the typical case there is a dispute concerning the amount that is owed on a claim.

*Case # 1.* The claim is for the price of goods or services sold to a consumer who asserts that he or she is not obliged to pay the full price for which the consumer was billed because of a defect or breach of warranty with respect to the goods or services.

*Case # 2.* A claim is made on an insurance policy. The insurance company alleges that it is not liable under the policy for the amount of the claim.

In either case the person against whom the claim is asserted may attempt an accord and satisfaction of the disputed claim by tendering a check to the claimant for some amount less than the full amount claimed by the claimant. A statement will be included on the check or in a communication accompanying the check to the effect that the check is offered as full payment or full satisfaction of the claim. Frequently, there is also a statement to the effect that obtaining payment of the check is an agreement by the claimant to a settlement of the dispute for the amount tendered. Before enactment of revised Article 3 (A.C.A. § 4-3-101 et seq.), the case law was in conflict over the question of

whether obtaining payment of the check had the effect of an agreement to the settlement proposed by the debtor. This issue was governed by a common law rule, but some courts hold that the common law was modified by former Section 1-207 which they interpreted as applying to full settlement checks.

2. Comment d. to Restatement of Contracts, Section 281 discusses the full satisfaction check and the applicable common law rule. In a case like Case # 1, the buyer can propose a settlement of the disputed bill by a clear notation on the check indicating that the check is tendered as full satisfaction of the bill. Under the common law rule the seller, by obtaining payment of the check accepts the offer of compromise by the buyer. The result is the same if the seller adds a notation to the check indicating that the check is accepted under protest or in only partial satisfaction of the claim. Under the common law rule the seller can refuse the check or can accept it subject to the condition stated by the buyer, but the seller can't accept the check and refuse to be bound by the condition. The rule applies only to an unliquidated claim or a claim disputed in good faith by the buyer. The dispute in the courts was whether Section 1-207 changed the common law rule. The Restatement states that section "need not be read as changing this well-established rule."



3. As part of the revision of Article 3 (A.C.A. § 4-3-101 et seq.), Section 1-207 (A.C.A. § 4-1-207) has been amended to add subsection (2) (A.C.A. § 4-1-207(2)) stating that Section 1-207 (A.C.A. § 4-1-207) "does not apply to an accord and satisfaction." Because of that amendment and revised Article 3 (A.C.A. § 4-3-101 et seq.), Section 3-311 (A.C.A. § 4-3-311) governs full satisfaction checks. Section 3-311 (A.C.A. § 4-3-311) follows the common law rule with some minor variations to reflect modern business conditions. In cases covered by Section 3-311 (A.C.A. § 4-3-311) there will often be an individual on one side of the dispute and a business organization on the other. This section is not designed to favor either the individual or the business organization. In Case # 1 the person seeking the accord and satisfaction is an individual. In Case # 2 the person seeking the accord and satisfaction is an insurance company. Section 3-311 (A.C.A. § 4-3-311) is based on a belief that the common law rule produces a fair result and that informal dispute resolution by full satisfaction checks should be encouraged.

4. Subsection (a) (A.C.A. § 4-3-311(a)) states three requirements for application of Section 3-311 (A.C.A. § 4-3-311). "Good faith" in subsection (a)(i) (A.C.A. § 4-3-311(a)(i)) is defined in Section 3-103(a)(4) (A.C.A. § 4-3-103(a)(4)) as not only honesty in fact, but the observance of reasonable commercial standards of fair dealing. The meaning of "fair dealing" will depend upon the facts in the particular case. For example, suppose an insurer tenders a check in settlement of a claim for personal injury in an accident clearly covered by the insurance policy. The claimant is necessitous and the amount of the check is very small in relationship to the extent of the injury and the amount recoverable under the policy. If the trier of fact determines that the insurer was taking unfair advantage of the claimant, an accord and satisfaction would not result from payment of the check because of the absence of good faith by the insurer in making the tender. Another example of lack of good faith is found in the practice of some business debtors in routinely printing full satisfaction language on their check stocks so that all or a large part of the debts of the debtor are paid by checks bearing the full satisfaction language,

whether or not there is any dispute with the creditor. Under such a practice the claimant cannot be sure whether a tender in full satisfaction is or is not being made. Use of a check on which full satisfaction language was affixed routinely pursuant to such a business practice may prevent an accord and satisfaction on the ground that the check was not tendered in good faith under subsection (a)(i) (A.C.A. § 4-3-311(a)(i)).

Section 3-311 (A.C.A. § 4-3-311) does not apply to cases in which the debt is a liquidated amount and not subject to a bona fide dispute. Subsection (a)(ii) (A.C.A. § 4-3-311(a)(ii)). Other law applies to cases in which a debtor is seeking discharge of such a debt by paying less than the amount owed. For the purpose of subsection (a)(iii) obtaining acceptance of a check is considered to be obtaining payment of the check.

The person seeking the accord and satisfaction must prove that the requirements of subsection (a) (A.C.A. § 4-3-311(a)) are met. If that person also proves that the statement required by subsection (b) (A.C.A. § 4-3-311(b)) was given, the claim is discharged unless subsection (c) (A.C.A. § 4-3-311(c)) applies. Normally the statement required by subsection (b) (A.C.A. § 4-3-311(b)) is written on the check. Thus, the canceled check can be used to prove the statement as well as the fact that the claimant obtained payment of the check. Subsection (b) (A.C.A. § 4-3-311(b)) requires a "conspicuous" statement that the instrument was tendered in full satisfaction of the claim. "Conspicuous" is defined in Section 1-201(10) (A.C.A. § 4-1-201(10)). The statement is conspicuous if "it is so written that a reasonable person against whom it is to operate ought to have noticed it." If the claimant can reasonably be expected to examine the check, almost any statement on the check should be noticed and is therefore conspicuous. In cases in which the claimant is an individual the claimant will receive the check and will normally indorse it. Since the statement concerning tender in full satisfaction normally will appear above the space provided for the claimant's indorsement of the check, the claimant "ought to have noticed" the statement.

5. Subsection (c)(1) (A.C.A. § 4-3-311(c)(1)) is a limitation on subsection (b)

(A.C.A. § 4-3-311(b)) in cases in which the claimant is an organization. It is designed to protect the claimant against inadvertent accord and satisfaction. If the claimant is an organization payment of the check might be obtained without notice to the personnel of the organization concerned with the disputed claim. Some business organizations have claims against very large numbers of customers. Examples are department stores, public utilities and the like. These claims are normally paid by checks sent by customers to a designated office at which clerks employed by the claimant or a bank acting for the claimant process the checks and record the amounts paid. If the processing office is not designed to deal with communications extraneous to recording the amount of the check and the account number of the customer, payment of a full satisfaction check can easily be obtained without knowledge by the claimant of the existence of the full satisfaction statement. This is particularly true if the statement is written on the reverse side of the check in the area in which indorsements are usually written. Normally, the clerks of the claimant have no reason to look at the reverse side of checks. Indorsement by the claimant normally is done by mechanical means or there may be no indorsement at all. Section 4-205(a) (A.C.A. § 4-4-205(a)). Subsection (c)(1) (A.C.A. § 4-3-311(c)(1)) allows the claimant to protect itself by advising customers by a conspicuous statement that communications regarding disputed debts must be sent to a particular person, office, or place. The statement must be given to the customer within a reasonable time before the tender is made. This requirement is designed to assure that the customer has reasonable notice that the full satisfaction check must be sent to a particular place. The reasonable time requirement could be satisfied by a notice on the billing statement sent to the customer. If the full satisfaction check is sent to the designated destination and the check is paid, the claim is discharged. If the claimant proves that the check was not received at the designated destination the claim is not discharged unless subsection (d) (A.C.A. § 4-3-311(d)) applies.

6. Subsection (c)(2) (A.C.A. § 4-3-311(c)(2)) is also designed to prevent inadvertent accord and satisfaction. It can be

used by a claimant other than an organization or by a claimant as an alternative to subsection (c)(1) (A.C.A. § 4-3-311(c)(1)). Some organizations may be reluctant to use subsection (c)(1) (A.C.A. § 4-3-311(c)(1)) because it may result in confusion of customers that causes checks to be routinely sent to the special designated person, office, or place. Thus, much of the benefit of rapid processing of checks may be lost. An organization that chooses not to send a notice complying with subsection (c)(1)(i) (A.C.A. § 4-3-311(c)(1)(i)) may prevent an inadvertent accord and satisfaction by complying with subsection (c)(2) (A.C.A. § 4-3-311(c)(2)). If the claimant discovers that it has obtained payment of a full satisfaction check, it may prevent an accord and satisfaction if, within 90 days of the payment of the check, the claimant tenders repayment of the amount of the check to the person against whom the claim is asserted.

7. Subsection (c) (A.C.A. § 4-3-311(c)) is subject to subsection (d) (A.C.A. § 4-3-311(d)). If a person against whom a claim is asserted proves that the claimant obtained payment of a check known to have been tendered in full satisfaction of the claim by "the claimant or an agent of the claimant having direct responsibility with respect to the disputed obligation," the claim is discharged even if (i) the check was not sent to the person, office, or place required by a notice complying with subsection (c)(1) (A.C.A. § 4-3-311(c)(1)), or (ii) the claimant tendered repayment of the amount of the check in compliance with subsection (c)(2) (A.C.A. § 4-3-311(c)(2)).

A claimant knows that a check was tendered in full satisfaction of a claim when the claimant "has actual knowledge" of that fact. Section 1-201(25) (A.C.A. § 4-1-201(25)). Under Section 1-201(27) (A.C.A. § 4-1-201(27)), if the claimant is an organization, it has knowledge that a check was tendered in full satisfaction of the claim when that fact is

"brought to the attention of the individual conducting that transaction, and in any event when it would have been brought to his attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person con-



ducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information."

With respect to an attempted accord and satisfaction the "individual conducting that transaction" is an employee or other agent of the organization having direct responsibility with respect to the dispute. For example, if the check and communication are received by a collection agency acting for the claimant to collect the disputed claim, obtaining payment of the check will result in an accord and satisfaction even if the claimant gave notice, pursuant to subsection (c)(1) (A.C.A. § 4-3-311(c)(1)), that full satisfaction checks be sent to some other office. Similarly, if a customer asserting a claim for breach of warranty with respect to defective goods purchased in a retail outlet of a large chain store delivers the full satisfaction check to the manager of the retail outlet at which the goods were purchased, obtaining payment of the check will also result in an accord and satisfaction. On the other hand, if the check is mailed to the chief executive officer of the chain store subsection (d) (A.C.A. § 4-3-311(d)) would probably not be satisfied. The chief executive officer of a large corporation may have general responsibility for operations of the company, but does not normally have direct responsibility for resolving a small disputed bill to a customer. A check for a relatively small amount mailed to a high executive officer of a large corporation is not likely to receive the executive's personal attention. Rather, the check would

normally be routinely sent to the appropriate office for deposit and credit to the customer's account. If the check does receive the personal attention of the high executive officer and the officer is aware of the full-satisfaction language, collection of the check will result in an accord and satisfaction because subsection (d) (A.C.A. § 4-3-311(d)) applies. In this case the officer has assumed direct responsibility with respect to the disputed transaction.

If a full satisfaction check is sent to a lock box or other office processing checks sent to the claimant, it is irrelevant whether the clerk processing the check did or did not see the statement that the check was tendered as full satisfaction of the claim. Knowledge of the clerk is not imputed to the organization because the clerk has no responsibility with respect to an accord and satisfaction. Moreover, there is no failure of "due diligence" under Section 1-201(27) (A.C.A. § 4-1-201(27)) if the claimant does not require its clerks to look for full satisfaction statements on checks or accompanying communications. Nor is there any duty of the claimant to assign that duty to its clerks. Section 3-311(c) (A.C.A. § 4-3-311(c)) is intended to allow a claimant to avoid an inadvertent accord and satisfaction by complying with either subsection (c)(1) or (2) (A.C.A. § 4-3-311(c)(1) or (2)) without burdening the check-processing operation with extraneous and wasteful additional duties.

8. In some cases the disputed claim may have been assigned to a finance company or bank as part of a financing arrangement with respect to accounts receivable. If the account debtor was notified of the assignment, the claimant is the assignee of the account receivable and the "agent of the claimant" in subsection (d) (A.C.A. § 4-3-311(d)) refers to an agent of the assignee.

### Official Comment to § 3-112 (A.C.A. § 4-3-112)

1. This section (A.C.A. § 4-3-212) applies to cases in which a cashier's check, teller's check, or certified check is lost, destroyed, or stolen. In one typical case a customer of a bank closes his or her account and takes a cashier's check or teller's check of the bank as payment of the amount of the account. The customer may be moving to a new area and the check is

to be used to open a bank account in that area. In such a case the check will normally be payable to the customer. In another typical case a cashier's check or teller's check is bought from a bank for the purpose of paying some obligation of the buyer of the check. In such a case the check may be made payable to the customer and then negotiated to the creditor

by indorsement. But often, the payee of the check is the creditor. In the latter case the customer is a remitter. The section (A.C.A. § 4-3-312) covers loss of the check by either the remitter or the payee. The section (A.C.A. § 4-3-312) also covers loss of a certified check by either the drawer or payee.

Under Section 3-309 (A.C.A. § 4-3-309) a person seeking to enforce a lost, destroyed, or stolen cashier's check or teller's check may be required by the court to give adequate protection to the issuing bank against loss that might occur by reason of the claim by another person to enforce the check. This might require the posting of an expensive bond for the amount of the check. Moreover, Section 3-309 (A.C.A. § 4-3-309) applies only to a person entitled to enforce the check. It does not apply to a remitter of a cashier's check or teller's check or to the drawer of a certified check. Section 3-312 (A.C.A. § 4-3-312) applies to both. The purpose of Section 3-312 (A.C.A. § 4-3-312) is to offer a person who loses such a check a means of getting refund of the amount of the check within a reasonable period of time without the expense of posting a bond and with full protection of the obligated bank.

2. A claim to the amount of a lost, destroyed, or stolen cashier's check, teller's check, or certified check may be made under subsection (b) (A.C.A. § 4-3-312(b)) if the following requirements of that subsection are met. First, a claim may be asserted only by the drawer or payee of a certified check or the remitter or payee of a cashier's check or teller's check. An indorsee of a check is not covered because the indorsee is not an original party to the check or a remitter. Limitation to an original party or remitter gives the obligated bank the ability to determine, at the time it becomes obligated on the check, the identity of the person or persons who can assert a claim with respect to the check. The bank is not faced with having to determine the rights of some person who was not a party to the check at that time or with whom the bank had not dealt. If a cashier's check is issued to the order of the person who purchased it from the bank and that person indorses it over to a third person who loses the check, the third person may assert rights to enforce the check under Section 3-309 (A.C.A. § 4-3-

309) but has no rights under Section 3-312 (A.C.A. § 4-3-312).

Second, the claim must be asserted by a communication to the obligated bank describing the check with reasonable certainty and requesting payment of the amount of the check. "Obligated bank" is defined in subsection (a)(4) (A.C.A. § 4-3-312(a)(4)). Third, the communication must be received in time to allow the obligated bank to act on the claim before the check is paid, and the claimant must provide reasonable identification if requested. Subsections (b)(iii) and (iv) (A.C.A. § 4-3-312(b)(iii) and (iv)). Fourth, the communication must contain or be accompanied by a declaration of loss described in subsection (b) (A.C.A. § 4-3-312(b)). This declaration is an affidavit or other writing made under penalty of perjury alleging the loss, destruction or theft of the check and stating that the declarer is a person entitled to assert a claim, i.e., the drawer or payee of a certified check or the remitter or payee of a cashier's check or teller's check.

A claimant who delivers a declaration of loss makes a warranty of the truth of the statements made in the declaration. The warranty is made to the obligated bank and anybody who has a right to enforce the check. If the declaration of loss falsely alleges loss of a cashier's check that did not in fact occur, a holder of the check who was unable to obtain payment because subsection (b)(3) and (4) (A.C.A. § 4-3-312(b)(3) and (4)) caused the obligated bank to dishonor the check would have a cause of action against the declarer for breach of warranty.

The obligated bank may not impose additional requirements on the claimant to assert a claim under subsection (b) (A.C.A. § 4-3-312(b)). For example, the obligated bank may not require the posting of a bond or other form of security. Section 3-312(b) (A.C.A. § 4-3-312(b)) states the procedure for asserting claims covered by the section. Thus, procedures that may be stated in other law for stating claims to property do not apply and are displaced within the meaning of Section 1-103 (A.C.A. § 4-1-103).

3. A claim asserted under subsection (b) (A.C.A. § 4-3-312(b)) does not have any legal effect, however, until the date it becomes enforceable, which cannot be earlier than 90 days after the date of a



cashier's check or teller's check or 90 days after the date of acceptance of a certified check. Thus, if a lost check is presented for payment within the 90-day period, the bank may pay a person entitled to enforce the check without regard to the claim and is discharged of all liability with respect to the check. This ensures the continued utility of cashier's checks, teller's checks, and certified checks as cash equivalents. Virtually all such checks are presented for payment within 90 days.

If the claim becomes enforceable and payment has not been made to a person entitled to enforce the check, the bank becomes obligated to pay the amount of the check to the claimant. Subsection (b)(4) (A.C.A. § 4-3-312(b)(4)). When the bank becomes obligated to pay the amount of the check to the claimant, the bank is relieved of its obligation to pay the check. Subsection (b)(3) (A.C.A. § 4-3-312(b)(3)). Thus, any person entitled to enforce the check, including even a holder in due course, loses the right to enforce the check after a claim under subsection (b) (A.C.A. § 4-3-312(b)) becomes enforceable.

If the obligated bank pays the claimant under subsection (b)(4) (A.C.A. § 4-3-312(b)(4)), the bank is discharged of all liability with respect to the check. The only exception is the unlikely case in which the obligated bank subsequently incurs liability under Section 4-302(a)(1) (A.C.A. § 4-3-302(a)(1)) with respect to the check. For example, Obligated Bank is the issuer of a cashier's check and, after a claim becomes enforceable, it pays the claimant under subsection (b)(4) (A.C.A. § 4-3-312(b)(4)). Later the check is presented to Obligated Bank for payment over the counter. Under subsection (b)(3) (A.C.A. § 4-3-312(b)(3)), Obligated Bank is not obliged to pay the check and may dishonor the check by returning it to the person who presented it for payment. But the normal rules of check collection are not affected by Section 3-312 (A.C.A. § 4-3-312). If Obligated Bank retains the check beyond midnight of the day of presentment without settling for it, it becomes accountable for the amount of the check under Section 4-302(a)(1) (A.C.A. § 4-3-302(a)(1)) even though it had no obligation to pay the check.

An obligated bank that pays the amount of a check to a claimant under

subsection (b)(4) (A.C.A. § 4-3-312(b)(4)) is discharged of all liability on the check so long as the assertion of the claim meets the requirements of subsection (b) (A.C.A. § 4-3-312(b)) discussed in Comment 2. This is important in cases of fraudulent declarations of loss. For example, if the claimant falsely alleges a loss that in fact did not occur, the bank, subject to Section 1-203 (A.C.A. § 4-1-203), may rely on the declaration of loss. On the other hand, a claim may be asserted only by a person described in subsection (b)(i) (A.C.A. § 4-3-312(b)(i)). Thus, the bank is discharged under subsection (a)(4) (A.C.A. § 4-3-312(a)(4)) only if it pays such a person. Although it is highly unlikely, it is possible that more than one person could assert a claim under subsection (b) (A.C.A. § 4-3-312(b)) to the amount of a check. Such a case could occur if one of the claimants makes a false declaration of loss. The obligated bank is not required to determine whether a claimant who complies with subsection (b) (A.C.A. § 4-3-312(b)) is acting wrongfully. The bank may utilize procedures outside this Article (A.C.A. § 4-3-301 et seq.) such as interpleader, under which the conflicting claims may be adjudicated.

Although it is unlikely that a lost check would be presented for payment after the claimant was paid by the bank under subsection (b)(4) (A.C.A. § 4-3-312(b)(4)), it is possible for it to happen. Suppose the declaration of loss by the claimant fraudulently alleged a loss that in fact did not occur. If the claimant negotiated the check, presentment for payment would occur shortly after negotiation in almost all cases. Thus, a fraudulent declaration of loss is not likely to occur unless the check is negotiated after the 90-day period has already expired or shortly before expiration. In such a case the holder of the check, who may not have noticed the date of the check, is not entitled to payment from the obligated bank if the check is presented for payment after the claim becomes enforceable. Subsection (b)(3) (A.C.A. § 4-3-312(b)(3)). The remedy of the holder who is denied payment in that case is an action against the claimant under subsection (c) (A.C.A. § 4-3-312(c)) if the holder is a holder in due course, or for breach of warranty under subsection (b) (A.C.A. § 4-3-312(b)). The holder would also have common law remedies

against the claimant under the law of restitution or fraud.

4. The following cases illustrate the operation of Section 3-312 (A.C.A. § 4-3-312):

**Case #1.** Obligated Bank (OB) certified a check drawn by its customer, Drawer (D), payable to Payee (P). Two days after the check was certified, D lost the check and then asserted a claim pursuant to subsection (b) (A.C.A. § 4-3-312(b)). The check had not been presented for payment when D's claim became enforceable 90 days after the check was certified. Under subsection (b)(4) (A.C.A. § 4-3-312(b)(4)), at the time D's claim became enforceable OB became obliged to pay D the amount of the check. If the check is later presented for payment, OB may refuse to pay the check and has no obligation to anyone to pay the check. Any obligation owed by D to P, for which the check was intended as payment, is unaffected because the check was never delivered to P.

**Case #2.** Obligated Bank (OB) issued a teller's check to Remitter (R) payable to Payee (P). R delivered the check to P in payment of an obligation. P lost the check and then asserted a claim pursuant to subsection (b) (A.C.A. § 4-3-312(b)). To carry out P's order, OB issued an order pursuant to Section 4-403(a) (A.C.A. § 4-4-403(a)) to the drawee of the teller's check to stop payment of the check effective on the 90th day after the date of the teller's check. The check was not presented for payment. On the 90th day after the date of the teller's check P's claim becomes enforceable and OB becomes obliged to pay P the amount of the check. As in Case #1, OB has no further liability with respect to the check to anyone. When R delivered the check to P, R's underlying obligation to P was discharged under Section 3-310 (A.C.A. § 4-3-310). Thus, R suffered no loss. Since P received the amount of the check, P also suffered no loss except with respect to the delay in receiving the amount of the check.

**Case #3.** Obligated Bank (OB) issued a cashier's check to its customer, Payee (P). Two days after issue, the check was stolen from P who then asserted a claim pursuant to subsection (b). Ten days after issue, the check was deposited by X in an account in Depository Bank (DB). X had found the check and forged the indorse-

ment of P. DB promptly presented the check to OB and obtained payment on behalf of X. On the 90th day after the date of the check P's claim becomes enforceable and P is entitled to receive the amount of the check from OB. Subsection (b)(4) (A.C.A. § 4-3-312(b)(4)). Although the check was presented for payment before P's claim became enforceable, OB is not discharged. Because of the forged indorsement X was not a holder and neither was OB. Thus, neither is a person entitled to enforce the check (Section 3-301) (A.C.A. § 4-3-301) and OB is not discharged under Section 3-602(a) (A.C.A. § 4-3-602(a)). Thus, under subsection (b)(4) (A.C.A. § 4-3-312(b)(4)), because OB did not pay a person entitled to enforce the check, OB must pay P. OB's remedy is against DB for breach of warranty under Section 4-208(a)(1) (A.C.A. § 4-4-208(a)(1)). As an alternative to the remedy under Section 3-312 (A.C.A. § 4-3-312), P could recover from DB for conversion under Section 3-420(a) (A.C.A. § 4-3-420(a)).

**Case #4.** Obligated Bank (OB) issued a cashier's check to its customer, Payee (P). P made an unrestricted blank indorsement of the check and mailed the check to P's bank for deposit to P's account. The check was never received by P's bank. When P discovered the loss, P asserted a claim pursuant to subsection (b) (A.C.A. § 4-3-312(b)). X found the check and deposited it in X's account in Depository Bank (DB) after indorsing the check. DB presented the check for payment before the end of the 90-day period after its date. OB paid the check. Because of the unrestricted blank indorsement by P, X became a holder of the check. DB also became a holder. Since the check was paid before P's claim became enforceable and payment was made to a person entitled to enforce the check, OB is discharged of all liability with respect to the check. Subsection (b)(2) (A.C.A. § 4-3-312(b)(2)). Thus, P is not entitled to payment from OB. Subsection (b)(4) (A.C.A. § 4-3-312(b)(4)) doesn't apply.

**Case #5.** Obligated Bank (OB) issued a cashier's check to its customer, Payee (P). P made an unrestricted blank indorsement of the check and mailed the check to P's bank for deposit to P's account. The check was never received by P's bank. When P discovered the loss, P asserted a claim pursuant to subsection (b) (A.C.A.



§ 4-3-312(b)). At the end of the 90-day period after the date of the check, OB paid the amount of the check to P under subsection (b)(4). X then found the check and deposited it to X's account in Depository Bank (DB). DB presented the check to OB for payment. OB is not obliged to pay the check. Subsection (b)(4) (A.C.A. § 4-3-312(b)(4)). If OB dishonors the check, DB's remedy is to charge back X's account. Section 4-214(a) (A.C.A. § 4-4-214(a)). Although P, as an indorser, would normally have liability to DB under Section 3-415(a) (A.C.A. § 4-3-415(a)) because the check was dishonored, P is released from that liability under Section 3-415(e) (A.C.A. § 4-3-415(e)) because collection of the check was initiated more than 30 days after the indorsement. DB has a remedy only against X. A depository bank that takes a cashier's check that cannot be presented for payment before expiration of the 90-day period after its date is on notice that the check might not be paid because of the possibility of a claim asserted under subsection (b) (A.C.A. § 4-3-312(b)) which would excuse the issuer of the check from paying the check. Thus, the depository bank cannot safely release funds with respect to the check until it has assurance that the check has been paid. DB

cannot be a holder in due course of the check because it took the check when the check was overdue. Section 3-304(a)(2) (A.C.A. § 4-3-304(a)(2)). Thus, DB has no action against P under subsection (c) (A.C.A. § 4-3-312(c)).

**Case #6.** Obligated Bank (OB) issued a cashier's check payable to bearer and delivered it to its customer, Remitter (R). R held the check for 90 days and then wrongfully asserted a claim to the amount of the check under subsection (b) (A.C.A. § 4-3-312(b)). The declaration of loss fraudulently stated that the check was lost. R received payment from OB under subsection (b)(4) (A.C.A. § 4-3-312(b)(4)). R then negotiated the check to X for value. X presented the check to OB for payment. Although OB, under subsection (b)(2) (A.C.A. § 4-3-312(b)(2)), was not obliged to pay the check, OB paid X by mistake. OB's teller did not notice that the check was more than 90 days old and was not aware that OB was not obliged to pay the check. If X took the check in good faith, OB may not recover from X. Section 3-418(c) (A.C.A. § 4-3-418(c)). OB's remedy is to recover from R for fraud or for breach of warranty in making a false declaration of loss. Subsection (b) (A.C.A. § 4-3-312(b)).

### Comment to § 3-401 (A.C.A. § 4-3-401)

1. Obligation on an instrument depends on a signature that is binding on the obligor. The signature may be made by the obligor personally or by an agent authorized to act for the obligor. Signature by agents is covered by Section 3-402 (A.C.A. § 4-3-402). It is not necessary that the name of the obligor appear on the instrument, so long as there is a signature that binds the obligor. Signature includes an indorsement.

2. A signature may be handwritten, typed, printed or made in any other manner. It need not be subscribed, and may appear in the body of the instrument, as in the case of "I, John Doe, promise to pay..."

without any other signature. It may be made by mark, or even by thumb-print. It may be made in any name, including any trade name or assumed name, however false and fictitious, which is adopted for the purpose. Parol evidence is admissible to identify the signer, and when the signer is identified the signature is effective. Indorsement in a name other than that of the indorser is governed by Section 3-204(d) (A.C.A. § 4-3-204(d)).

This section (A.C.A. § 4-3-401) is not intended to affect any other law requiring a signature by mark to be witnessed, or any signature to be otherwise authenticated, or requiring any form of proof.

**Comment to § 3-402 (A.C.A. § 4-3-402)**

1. Subsection (a) (A.C.A. § 4-3-402(a)) states when the represented person is bound on an instrument if the instrument is signed by a representative. If under the law of agency the represented person would be bound by the act of the representative in signing either the name of the represented person or that of the representative, the signature is the authorized signature of the represented person. Former Section 3-401(1) stated that "no person is liable on an instrument unless his signature appears thereon." This was interpreted as meaning that an undisclosed principal is not liable on an instrument. This interpretation provided an exception to ordinary agency law that binds an undisclosed principal on a simple contract.

It is questionable whether this exception was justified by the language of former Article 3 and there is no apparent policy justification for it. The exception is rejected by subsection (a) (A.C.A. § 4-3-402(a)) which returns to ordinary rules of agency. If P, the principal, authorized A, the agent, to borrow money on P's behalf and A signed A's name to a note without disclosing that the signature was on behalf of P, A is liable on the instrument. But if the person entitled to enforce the note can also prove that P authorized A to sign on P's behalf, why shouldn't P also be liable on the instrument? To recognize the liability of P takes nothing away from the utility of negotiable instruments. Furthermore, imposing liability on P has the merit of making it impossible to have an instrument on which nobody is liable even though it was authorized by P. That result could occur under former Section 3-401(1) if an authorized agent signed "as agent" but the note did not identify the principal. If the dispute was between the agent and the payee of the note, the agent could escape liability on the note by proving that the agent and the payee did not intend that the agent be liable on the note when the note was issued. Former Section 3-403(2)(b). Under the prevailing interpretation of former Section 3-401(1), the principal was not liable on the note under former Section 3-401(1) because the principal's name did not appear on the note. Thus, nobody was liable on the note even

though all parties knew that the note was signed by the agent on behalf of the principal. Under Section 3-402(a) (A.C.A. § 4-3-402(a)) the principal would be liable on the note.

2. Subsection (b) (A.C.A. § 4-3-402(b)) concerns the question of when an agent who signs an instrument on behalf of a principal is bound on the instrument. The approach followed by former Section 3-403 was to specify the form of signature that imposed or avoided liability. This approach was unsatisfactory. There are many ways in which there can be ambiguity about a signature. It is better to state a general rule. Subsection (b)(1) (A.C.A. § 4-3-402(b)(1)) states that if the form of the signature unambiguously shows that it is made on behalf of an identified represented person (for example, "P, by A, Treasurer") the agent is not liable. This is a workable standard for a court to apply. Subsection (b)(2) (A.C.A. § 4-3-402(b)(2)) partly changes former Section 3-403(2). Subsection (b)(2) (A.C.A. § 4-3-402(b)(2)) relates to cases in which the agent signs on behalf of a principal but the form of the signature does not fall within subsection (b)(1) (A.C.A. § 4-3-402(b)(1)). The following cases are illustrative. In each case John Doe is the authorized agent of Richard Roe and John Doe signs a note on behalf of Richard Roe. In each case the intention of the original parties to the instrument is that Roe is to be liable on the instrument but Doe is not to be liable.

*Case # 1.* Doe signs "John Doe" without indicating in the note that Doe is signing as agent. The note does not identify Richard Roe as the represented person.

*Case # 2.* Doe signs "John Doe, Agent" but the note does not identify Richard Roe as the represented person.

*Case # 3.* The name "Richard Roe" is written on the note and immediately below that name Doe signs "John Doe" without indicating that Doe signed as agent.

In each case Doe is liable on the instrument to a holder in due course without notice that Doe was not intended to be liable. In none of the cases does Doe's signature unambiguously show that Doe was signing as agent for an identified



principal. A holder in due course should be able to resolve any ambiguity against Doe.

But the situation is different if a holder in due course is not involved. In each case Roe is liable on the note. Subsection (a) (A.C.A. § 4-3-402(a)). If the original parties to the note did not intend that Doe also be liable, imposing liability on Doe is a windfall to the person enforcing the note. Under subsection (b)(2) (A.C.A. § 4-3-402(b)(2)) Doe is *prima facie* liable because his signature appears on the note and the form of the signature does not unambiguously refute personal liability. But Doe can escape liability by proving that the original parties did not intend that he be liable on the note. This is a change from former Section 3-403(2)(a).

A number of cases under former Article 3 involved situations in which an agent signed the agent's name to a note, without qualification and without naming the person represented, intending to bind the principal but not the agent. The agent attempted to prove that the other party had the same intention. Some of these cases involved mistake, and in some there was evidence that the agent may have been deceived into signing in that matter. In some of the cases the court refused to allow proof of the intention of the parties and imposed liability on the agent based on former Section 3-403(2)(a) even though

both parties to the instrument may have intended that the agent not be liable. Subsection (b)(2) (A.C.A. § 4-3-402(b)(2)) changes the result of those cases, and is consistent with Section 3-117 (A.C.A. § 4-3-117) which allows oral or written agreements to modify or nullify apparent obligations on the instrument.

Former Section 3-403 spoke of the represented person being "named" in the instrument. Section 3-402 (A.C.A. § 4-3-402) speaks of the represented person being "identified" in the instrument. This change in terminology is intended to reject decisions under former Section 3-403(2) requiring that the instrument state the legal name of the represented person.

3. Subsection (c) (A.C.A. § 4-3-402(c)) is directed at the check cases. It states that if the check identifies the represented person the agent who signs on the signature line does not have to indicate agency status. Virtually all checks used today are in personalized form which identify the person on whose account the check is drawn. In this case, nobody is deceived into thinking that the person signing the check is meant to be liable. This subsection (A.C.A. § 4-3-102(c)) is meant to overrule cases decided under former Article 3 such as *Griffin v. Ellinger*, 538 S.W.2d 97 (Texas 1976).

### Comment to § 3-403 (A.C.A. § 4-3-403)

1. "Unauthorized" signature is defined in Section 1-201(43) (A.C.A. § 4-1-201(43)) as one that includes a forgery as well as a signature made by one exceeding actual or apparent authority. Former Section 3-404(1) stated that an unauthorized signature was inoperative as the signature of the person whose name was signed unless that person "is precluded from denying it." Under former Section 3-406 if negligence by the person whose name was signed contributed to an unauthorized signature, that person "is precluded from asserting the ... lack of authority." Both of these sections were applied to cases in which a forged signature appeared on an instrument and the person asserting rights on the instrument alleged that the negligence of the purported signer contributed to the forgery. Since the standards for liability between the two sections differ, the overlap between the

sections caused confusion. Section 3-403(a) (A.C.A. § 4-3-403(a)) deals with the problem by removing the preclusion language that appeared in former Section 3-404.

2. The except clause of the first sentence of subsection (a) (A.C.A. § 4-3-403(a)) states the generally accepted rule that the unauthorized signature, while it is wholly inoperative as that of the person whose name is signed, is effective to impose liability upon the signer or to transfer any rights that the signer may have in the instrument. The signer's liability is not in damages for breach of warranty of authority, but is full liability on the instrument in the capacity in which the signer signed. It is, however, limited to parties who take or pay the instrument in good faith; and one who knows that the signature is unauthorized cannot recover from the signer on the instrument.

3. The last sentence of subsection (a) (A.C.A. § 4-3-403(a)) allows an unauthorized signature to be ratified. Ratification is a retroactive adoption of the unauthorized signature by the person whose name is signed and may be found from conduct as well as from express statements. For example, it may be found from the retention of benefits received in the transaction with knowledge of the unauthorized signature. Although the forger is not an agent, ratification is governed by the rules and principles applicable to ratification of unauthorized acts of an agent.

Ratification is effective for all purposes of this Article (Chapter) (A.C.A. § 4-3-101 et seq.). The unauthorized signature becomes valid so far as its effect as a signature is concerned. Although the ratification may relieve the signer of liability on the instrument, it does not of itself relieve the signer of liability to the person whose name is signed. It does not in any way affect the criminal law. No policy of the criminal law prevents a person whose name is forged to assume liability to others on the instrument by ratifying the forgery, but the ratification cannot affect the rights of the state. While the ratification may be taken into account with other relevant facts in determining punishment, it does not relieve the signer of criminal liability.

4. Subsection (b) (A.C.A. § 4-3-403(b)) clarifies the meaning of "unauthorized" in cases in which an instrument contains less than all of the signatures that are required as authority to pay a check. Ju-

dicial authority was split on the issue whether the one-year notice period under former Section 4-406(4) (now Section 4-406(f) (A.C.A. § 4-4-406(f))) barred a customer's suit against a payor bank that paid a check containing less than all of the signatures required by the customer to authorize payment of the check. Some cases took the view that if a customer required that a check contain the signatures of both A and B to authorize payment and only A signed, there was no unauthorized signature within the meaning of that term in former Section 4-406(4) because A's signature was neither unauthorized nor forged. The other cases correctly pointed out that it was the customer's signature at issue and not that of A; hence, the customer's signature was unauthorized if all signatures required to authorize payment of the check were not on the check. Subsection (b) (A.C.A. § 4-3-403(b)) follows the latter line of cases. The same analysis applies if A forged the signature of B. Because the forgery is not effective as a signature of B, the required signature of B is lacking.

Subsection (b) (A.C.A. § 4-3-403(b)) refers to "the authorized signature of an organization." The definition of "organization" in Section 1-201(28) (A.C.A. § 4-1-201(28)) is very broad. It covers not only commercial entities but also "two or more persons having a joint or common interest." Hence subsection (b) (A.C.A. § 4-3-403(b)) would apply when a husband and wife are both required to sign an instrument.

#### Comment to § 3-404 (A.C.A. § 4-3-404)

1. Under former Article 3, the impostor cases were governed by former Section 3-405(1)(a) and the fictitious payee cases were governed by Section 3-405(1)(b). Section 3-404 (A.C.A. § 4-3-404) replaces former Section 3-405(1)(a) and (b) and modifies the previous law in some respects. Former Section 3-405 was read by some courts to require that the indorsement be in the exact name of the named payee. Revised Article 3 (A.C.A. § 4-3-101 et seq.) rejects this result. Section 3-404(c) (A.C.A. § 4-3-404(c)) requires only that the indorsement be made in a name "substantially similar" to that of the payee. Subsection (c) (A.C.A. § 4-3-404(c)) also recognizes the fact that checks may be

deposited without indorsement. Section 4-205(a) (A.C.A. § 4-4-205(a)).

Subsection (a) (A.C.A. § 4-3-404(a)) changes the former law in a case in which the impostor is impersonating an agent. Under former Section 3-405(1)(a), if Impostor impersonated Smith and induced the drawer to draw a check to the order of Smith, Impostor could negotiate the check. If Impostor impersonated Smith, the president of Smith Corporation, and the check was payable to the order of Smith Corporation, the section did not apply. See the last paragraph of Comment 2 to former Section 3-405. In revised Article 3 (A.C.A. § 4-3-101 et seq.), Section 3-404(a) (A.C.A. § 4-3-404(a)) gives Im-



postor the power to negotiate the check in both cases.

2. Subsection (b) (A.C.A. § 4-3-404(b)) is based in part on former Section 3-405(a)(b) and in part on N.I.L. § 9(3). It covers cases in which an instrument is payable to a fictitious or nonexisting person and to cases in which the payee is a real person but the drawer or maker does not intend the payee to have any interest in the instrument. Subsection (b) (A.C.A. § 4-3-404(b)) applies to any instrument, but its primary importance is with respect to checks of corporations and other organizations. It also applies to forged check cases. The following cases illustrate subsection (b) (A.C.A. § 4-3-404(b)):

*Case # 1.* Treasurer is authorized to draw checks in behalf of Corporation. Treasurer fraudulently draws a check of Corporation payable to Supplier Co., a non-existent company. Subsection (b) (A.C.A. § 4-3-404(b)) applies because Supplier Co. is a fictitious person and because Treasurer did not intend Supplier Co. to have any interest in the check. Under subsection (b)(1) (A.C.A. § 4-3-404(b)(1)) Treasurer, as the person in possession of the check, becomes the holder of the check. Treasurer indorses the check in the name "Supplier Co." and deposits it in Depositary Bank. Under subsection (b)(2) and (c)(i) (A.C.A. § 4-3-404(b)(2) and (c)(i)), the indorsement is effective to make Depositary Bank the holder and therefore a person entitled to enforce the instrument. Section 3-301 (A.C.A. § 4-3-301).

*Case # 2.* Same facts as Case # 1 except that Supplier Co. is an actual company that does business with Corporation. If Treasurer intended to steal the check when the check was drawn, the result in Case # 2 is the same as the result in Case # 1. Subsection (b) (A.C.A. § 4-3-404(b)) applies because Treasurer did not intend Supplier Co. to have any interest in the check. It does not make any difference whether Supplier Co. was or was not a creditor of Corporation when the check was drawn. If Treasurer did not decide to steal the check until after the check was drawn, the case is covered by Section 3-405 (A.C.A. § 4-3-405) rather than Section 3-404(b) (A.C.A. § 4-3-404(b)),

but the result is the same. See Case # 6 in Comment 3 to Section 3-405 (A.C.A. § 4-3-405).

*Case # 3.* Checks of Corporation must be signed by two officers. President and Treasurer both sign a check of Corporation payable to Supplier Co., a company that does business with Corporation from time to time but to which Corporation does not owe any money. Treasurer knows that no money is owed to Supplier Co. and does not intend that Supplier Co. have any interest in the check. President believes that money is owed to Supplier Co. Treasurer obtains possession of the check after it is signed. Subsection (b) (A.C.A. § 4-3-404(b)) applies because Treasurer is "a person whose intent determines to whom an instrument is payable" and Treasurer does not intend Supplier Co. to have any interest in the check. Treasurer becomes the holder of the check and may negotiate it by indorsing it in the name "Supplier Co."

*Case # 4.* Checks of Corporation are signed by a check-writing machine. Names of payees of checks produced by the machine are determined by information entered into the computer that operates the machine. Thief, a person who is not an employee or other agent of Corporation, obtains access to the computer and causes the check-writing machine to produce a check payable to Supplier Co., a non-existent company. Subsection (b)(ii) (A.C.A. § 4-3-404(b)(ii)) applies. Thief then obtains possession of the check. At that point Thief becomes the holder of the check because Thief is the person in possession of the instrument. Subsection (b)(1) (A.C.A. § 4-3-404(b)(1)). Under Section 3-301 (A.C.A. § 4-3-301) Thief, as holder, is the "person entitled to enforce the instrument" even though Thief does not have title to the check and is in wrongful possession of it. Thief indorses the check in the name "Supplier Co." and deposits it in an account in Depositary Bank which Thief opened in the name "Supplier Co." Depositary Bank takes the check in good faith and credits the "Supplier Co." account. Under subsection (b)(2) and (c)(i) (A.C.A. § 4-3-404(b)(2) and

(c)(i)), the indorsement is effective. Depository Bank becomes the holder and the person entitled to enforce the check. The check is presented to the drawee bank for payment and payment is made. Thief then withdraws the credit to the account. Although the check was issued without authority given by Corporation, the drawee bank is entitled to pay the check and charge Corporation's account if there was an agreement with Corporation allowing the bank to debit Corporation's account for payment of checks produced by the check-writing machine whether or not authorized. The indorsement is also effective if Supplier Co. is a real person. In that case subsection (b)(i) (A.C.A. § 4-3-404(b)(i)) applies. Under Section 3-110(b) (A.C.A. § 4-3-110(b)) Thief is the person whose intent determines to whom the check is payable, and Thief did not intend Supplier Co. to have any interest in the check. When the drawee bank pays the check, there is no breach of warranty under Section 3-417(a)(1) or 4-208(a)(1) (A.C.A. § 4-3-417(a)(1) or § 4-4-208(a)(1)) because Depository Bank was a person entitled to enforce the check when it was forwarded for payment.

*Case # 5.* Thief, who is not an employee or agent of Corporation, steals check forms of Corporation. John Doe is president of Corporation and is authorized to sign checks on behalf of Corporation as drawer. Thief draws a check in the name of Corporation as drawer by forging the signature of Doe. Thief makes the check payable to the order of Supplier Co. with the intention of stealing it. Whether Supplier Co. is a fictitious person or a real person, Thief becomes the holder of the check and the person entitled to enforce it. The analysis is the same as that in Case # 4. Thief deposits the check in an account in Depository Bank which Thief opened in the name "Supplier Co." Thief either indorses the check in a name other than "Supplier Co." or does not indorse the check at all. Under Section 4-205(a) (A.C.A. § 4-4-205(a)) a depository bank may become holder of a check deposited to the account of a customer

if the customer was a holder, whether or not the customer indorses. Subsection (c)(ii) (A.C.A. § 4-3-404(c)(ii)) treats deposit to an account in a name substantially similar to that of the payee as the equivalent of indorsement in the name of the payee. Thus, the deposit is an effective indorsement of the check. Depository Bank becomes the holder of the check and the person entitled to enforce the check. If the check is paid by the drawee bank, there is no breach of warranty under Section 3-417(a)(1) or 4-208(a)(1) (A.C.A. §§ 4-3-417(a)(1) and 4-4-208(a)(1)) because Depository Bank was a person entitled to enforce the check when it was forwarded for payment and, unless Depository Bank knew about the forgery of Doe's signature, there is no breach of warranty under Section 3-417(a)(3) or 4-208(a)(3) (A.C.A. §§ 4-3-417(a)(3) and 4-4-208(a)(3)). Because the check was a forged check the drawee bank is not entitled to charge Corporation's account unless Section 3-406 (A.C.A. § 4-3-406) or Section 4-406 (A.C.A. § 4-4-406) applies.

3. In cases governed by subsection (a) (A.C.A. § 4-3-404(a)) the dispute will normally be between the drawer of the check that was obtained by the impostor and the drawee bank that paid it. The drawer is precluded from obtaining recredit of the drawer's account by arguing that the check was paid on a forged indorsement so long as the drawee bank acted in good faith in paying the check. Cases governed by subsection (b) (A.C.A. § 4-3-404(b)) are illustrated by Cases # 1 through # 5 in Comment 2. In Cases # 1, # 2, and # 3 there is no forgery of the check, thus the drawer of the check takes the loss as there is no lack of good faith by the banks involved. Cases # 4 and # 5 are forged check cases. Depository Bank is entitled to retain the proceeds of the check if it didn't know about the forgery. Under Section 3-418 (A.C.A. § 4-3-418) the drawee bank is not entitled to recover from Depository Bank on the basis of payment by mistake because Depository Bank took the check in good faith and gave value for the check when the credit given for the check was withdrawn. And there is no breach of warranty under Section 3-417(a)(1) or (3) or 4-208(a)(1) or (3)



(A.C.A. §§ 4-3-417(a)(1) or (3) and 4-4-208(a)(1) or (3)). Unless Section 3-406 (A.C.A. § 4-3-406) applies the loss is taken by the drawee bank if a forged check is paid, and that is the result in Case # 5. In Case # 4 the loss is taken by Corporation, the drawer, because an agreement between Corporation and the drawee bank allowed the bank to debit Corporation's account despite the unauthorized use of the check-writing machine.

If a check payable to an impostor, fictitious payee, or payee not intended to have an interest in the check is paid, the effect of subsections (a) and (b) (A.C.A. § 4-3-404(a) and (b)) is to place the loss on the drawer of the check rather than on the drawee or the Depository Bank that took the check for collection. Cases governed by subsection (a) (A.C.A. § 4-3-404(a)) always involve fraud, and fraud is almost always involved in cases governed by subsection (b) (A.C.A. § 4-3-404(b)). The drawer is in the best position to avoid the fraud and thus should take the loss. This is true in Case # 1, Case # 2, and Case # 3. But in some cases the person taking the check might have detected the fraud and thus have prevented the loss by the exercise of ordinary care. In those cases, if that person failed to exercise ordinary care, it is reasonable that that person bear loss to the extent the failure contributed to the loss. Subsection (d) (A.C.A. § 4-3-404(d)) is intended to reach that result. It allows the person who suffers loss as a result of payment of the check to recover from the person who failed to exercise ordinary care. In Case # 1, Case # 2, and Case # 3, the person suffering the loss is Corporation, the drawer of the check. In each case the most likely defendant is the depository bank that took the check and failed to exercise ordinary care. In those cases, the drawer has a cause of action against the offending bank to recover a portion of the loss. The amount of loss to be allocated to each party is left to the trier of fact. Ordinary care is defined in Section 3-103(a)(7) (A.C.A. § 4-3-103(a)(7)). An example of the type of conduct by a depository bank that could give rise to recovery under subsection (d) (A.C.A. § 4-3-404(d))

is discussed in Comment 4 to Section 3-405 (A.C.A. § 4-3-405). That comment addresses the last sentence of Section 3-405(b) (A.C.A. § 4-3-405(b)) which is similar to Section 3-404(d) (A.C.A. § 4-3-404(d)).

In Case # 1, Case # 2, and Case # 3, there was no forgery of the drawer's signature. But cases involving checks payable to a fictitious payee or a payee not intended to have an interest in the check are often forged check cases as well. Examples are Case # 4 and Case # 5. Normally, the loss in forged check cases is on the drawee bank that paid the check. Case # 5 is an example. In Case # 4 the risk with respect to the forgery is shifted to the drawer because of the agreement between the drawer and the drawee bank. The doctrine that prevents a drawee bank from recovering payment with respect to a forged check if the payment was made to a person who took the check for value and in good faith is incorporated into Section 3-418 (A.C.A. § 4-3-418) and Sections 3-417(a)(3) and 4-208(a)(3) (A.C.A. §§ 4-3-417(a)(3) and 4-4-208(a)(3)). This doctrine is based on the assumption that the depository bank normally has no way of detecting the forgery because the drawer is not that bank's customer. On the other hand, the drawee bank, at least in some cases, may be able to detect the forgery by comparing the signature on the check with the specimen signature that the drawee has on file. But in some forged check cases the depository bank is in a position to detect the fraud. Those cases typically involve a check payable to a fictitious payee or a payee not intended to have an interest in the check. Subsection (d) (A.C.A. § 4-3-404(d)) applies to those cases. If the depository bank failed to exercise ordinary care and the failure substantially contributed to the loss, the drawer in Case # 4 or the drawee bank in Case # 5 has a cause of action against the depository bank under subsection (d) (A.C.A. § 4-3-404(d)). Comment 4 to Section 3-405 (A.C.A. § 4-3-405) can be used as a guide to the type of conduct that could give rise to recovery under Section 3-404(d) (A.C.A. § 4-3-404(d)).

**Comment to § 3-405 (A.C.A. § 4-3-405)**

1. Section 3-405 (A.C.A. § 4-3-405) is addressed to fraudulent indorsements made by an employee with respect to instruments with respect to which the employer has given responsibility to the employee. It covers two categories of fraudulent indorsements: indorsements made in the name of employer to instruments payable to the employer and indorsements made in the name of payees of instruments issued by the employer. This section (A.C.A. § 4-3-405) applies to instruments generally but normally the instrument will be a check. Section 3-405 (A.C.A. § 4-3-405) adopts the principle that the risk of loss for fraudulent indorsements by employees who are entrusted with responsibility with respect to checks should fall on the employer rather than the bank that takes the check or pays it, if the bank was not negligent in the transaction. Section 3-405 (A.C.A. § 4-3-405) is based on the belief that the employer is in a far better position to avoid the loss by care in choosing employees, in supervising them, and in adopting other measures to prevent forged indorsements on instruments payable to the employer or fraud in the issuance of instruments payable to the employer or fraud in the issuance of instruments in the name of the employer. If the bank failed to exercise ordinary care, subsection (b) (A.C.A. § 4-3-405(b)) allows the employer to shift loss to the bank to the extent the bank's failure to exercise ordinary care contributed to the loss. "Ordinary care" is defined in Section 3-103(a)(7) (A.C.A. § 4-3-103(a)(7)). The provision applies regardless of whether the employer is negligent.

The first category of cases governed by Section 3-405 (A.C.A. § 4-3-405) are those involving indorsements made in the name of payees of instruments issued by the employer. In this category, Section 3-405 (A.C.A. § 4-3-405) includes cases that were covered by former Section 3-405(1)(c). The scope of Section 3-405 (A.C.A. § 4-3-405) in revised Article 3 (A.C.A. § 4-3-101 et seq.) is, however, somewhat wider. It covers some cases not covered by former Section 3-405(1)(c) in which the entrusted employee makes a forged indorsement to a check drawn by

the employer. An example is Case # 6 in Comment 3. Moreover, a larger group of employees is included in revised Section 3-405 (A.C.A. § 4-3-405). The key provision is the definition of "responsibility" in subsection (a)(1) (A.C.A. § 4-3-405(a)(1)) which identifies the kind of responsibility delegated to an employee which will cause the employer to take responsibility for the fraudulent acts of that employee. An employer can insure this risk by employee fidelity bonds.

The second category of cases governed by Section 3-405 (A.C.A. § 4-3-405) — fraudulent indorsements of the name of the employer to instruments payable to the employer — were covered in former Article 3 by Section 3-406. Under former Section 3-406, the employer took the loss only if negligence of the employer could be proved. Under revised Article 3 (A.C.A. § 4-3-101 et seq.), Section 3-406 (A.C.A. § 4-3-406) need not be used with respect to forgeries of the employer's indorsement. Section 3-405 (A.C.A. § 4-3-405) imposes the loss on the employer without proof of negligence.

2. With respect to cases governed by former Section 3-405(1)(c), Section 3-405 (A.C.A. § 4-3-405) is more favorable to employers in one respect. The bank was entitled to the preclusion provided by former Section 3-405(1)(c) if it took the check in good faith. The fact that the bank acted negligently did not shift the loss to the bank so long as the bank acted in good faith. Under revised Section 3-405 (A.C.A. § 4-3-405) the loss may be recovered from the bank to the extent the failure of the bank to exercise ordinary care contributed to the loss.

3. Section 3-404(b) and Section 3-405 (A.C.A. §§ 4-3-404(b) and 4-3-405) both apply to cases of employee fraud. Section 3-404(b) (A.C.A. § 4-3-404(b)) is not limited to cases of employee fraud, but most of the cases to which it applies will be cases of employee fraud. The following cases illustrate the application of Section 3-405 (A.C.A. § 4-3-405). In each case it is assumed that the bank that took the check acted in good faith and was not negligent.

*Case # 1.* Janitor, an employee of Employer, steals a check for a very



large amount payable to Employer after finding it on a desk in one of Employer's offices. Janitor forges Employer's indorsement on the check and obtains payment. Since Janitor was not entrusted with "responsibility" with respect to the check, Section 3-405 (A.C.A. § 4-3-405) does not apply. Section 3-406 (A.C.A. § 4-3-406) might apply to this case. The issue would be whether Employer was negligent in safeguarding the check. If not, Employer could assert that the indorsement was forged and bring an action for conversion against the depository or payor bank under Section 3-420 (A.C.A. § 4-3-420).

*Case # 2.* X is Treasurer of Corporation and is authorized to write checks on behalf of Corporation by signing X's name as Treasurer. X draws a check in the name of Corporation and signs X's name as Treasurer. The check is made payable to X. X then indorses the check and obtains payment. Assume that Corporation did not owe any money to X and did not authorize X to write the check. Although the writing of the check was not authorized, Corporation is bound as drawer of the check because X had authority to sign checks on behalf of Corporation. This result follows from agency law and Section 3-402(a) (A.C.A. § 4-3-402(a)). Section 3-405 (A.C.A. § 4-3-405) does not apply in this case because there is no forged indorsement. X was payee of the check so the indorsement is valid. Section 3-110(a) (A.C.A. § 4-3-110(a)).

*Case # 3.* The duties of Employee, a bookkeeper, include posting the amounts of checks payable to Employer to the accounts of the drawers of the checks. Employee steals a check payable to Employer which was entrusted to Employee and forges Employer's indorsement. The check is deposited by Employee to an account in Depository Bank which Employee opened in the same name as Employer, and the check is honored by the drawee bank. The indorsement is effective as Employer's indorsement because Employee's duties include processing checks for bookkeeping purposes. Thus, Employee is en-

trusted with "responsibility" with respect to the check. Neither Depository Bank nor the drawee bank is liable to Employer for conversion of the check. The same result follows if Employee deposited the check in the account in Depository Bank without indorsement. Section 4-205(a) (A.C.A. § 4-4-205(a)). Under subsection (c) (A.C.A. § 4-3-405(c)) deposit in a depository bank in an account in a name substantially similar to that of Employer is the equivalent of an indorsement in the name of Employer.

*Case # 4.* Employee's duties include stamping Employer's unrestricted blank indorsement on checks received by Employer and depositing them in Employer's bank account. After stamping Employer's unrestricted blank indorsement on a check, Employee steals the check and deposits it in Employee's personal bank account. Section 3-405 (A.C.A. § 4-3-405) doesn't apply because there is no forged indorsement. Employee is authorized by Employer to indorse Employer's checks. The fraud by Employee is not the indorsement but rather the theft of the indorsed check. Whether Employer has a cause of action against the bank in which the check was deposited is determined by whether the bank had notice of the breach of fiduciary duty by Employee. The issue is determined under Section 3-307 (A.C.A. § 4-3-307).

*Case # 5.* The computer that controls Employer's check-writing machine was programmed to cause a check to be issued to Supplier Co. to which money was owed by Employer. The address of Supplier Co. was included in the information in the computer. Employee is an accounts payable clerk whose duties include entering information into the computer. Employee fraudulently changed the address of Supplier Co. in the computer data bank to an address of Employee. The check was subsequently produced by the check-writing machine and mailed to the address that Employee had entered into the computer. Employee obtained possession of the check, indorsed it in the name of Supplier Co., and deposited it to an account in Depository Bank which

Employee opened in the name "Supplier Co." The check was honored by the drawee bank. The indorsement is effective under Section 3-405(b) (A.C.A. § 4-3-405(b)) because Employee's duties allowed Employee to supply information determining the address of the payee of the check. An employee that is entrusted with duties that enable the employee to determine the address to which a check is to be sent controls the disposition of the check and facilitates forgery of the indorsement. The employer is held responsible. The drawee may debit the account of Employer for the amount of the check. There is no breach of warranty by Depository Bank under Section 3-417(a)(1) or Section 4-208(a)(1) (A.C.A. §§ 4-3-417(a)(1) or 4-4-208(a)(1)).

*Case # 6.* Treasurer is authorized to draw checks in behalf of Corporation. Treasurer draws a check of Corporation payable to Supplier Co., a company that sold goods to Corporation. The check was issued to pay the price of these goods. At the time the check was signed Treasurer had no intention of stealing the check. Later, Treasurer stole the check, indorsed it in the name "Supplier Co." and obtained payment by depositing it to an account in Depository Bank which Treasurer opened in the name "Supplier Co.". The indorsement is effective under Section 3-405(b) (A.C.A. § 4-3-405(b)). Section 3-404(b) (A.C.A. § 4-3-404(b)) does not apply to this case.

*Case # 7.* Checks of Corporation are signed by Treasurer in behalf of Corporation as drawer. Clerk's duties include the preparation of checks for issue by Corporation. Clerk prepares a check payable to the order of Supplier Co. for Treasurer's signature. Clerk fraudulently informs Treasurer that the check is needed to pay a debt owed to Supplier Co., a company that does business with Corporation. No money is owed to Supplier Co. and Clerk intends to steal the check. Treasurer signs it and returns it to Clerk for mailing. Clerk does not indorse the check but deposits it to an account in Depository Bank which Clerk opened in the name "Supplier Co.". The check is honored by the drawee

bank. Section 3-404(b)(i) (A.C.A. § 4-3-404(b)(i)) does not apply to this case because Clerk, under Section 3-110(a) (A.C.A. § 4-3-110(a)), is not the person whose intent determines to whom the check is payable. But Section 3-405 (A.C.A. § 4-3-405) does apply and it treats the deposit by Clerk as an effective indorsement by Clerk because Clerk was entrusted with responsibility with respect to the check. If Supplier Co. is a fictitious person Section 3-404(b)(ii) (A.C.A. § 4-3-404(b)(ii)) applies. But the result is the same. Clerk's deposit is treated as an effective indorsement of the check whether Supplier Co. is a fictitious or a real person or whether money was or was not owing to Supplier Co. The drawee bank may debit the account of Corporation for the amount of the check and there is no breach of warranty by Depository Bank under Section 3-417(1)(a) (A.C.A. § 4-3-417(1)(a)).

4. The last sentence of subsection (b) (A.C.A. § 4-3-405(b)) is similar to subsection (d) of Section 3-404 (A.C.A. § 4-3-404(d)) which is discussed in Comment 3 to Section 3-404 (A.C.A. § 4-3-404). In Case # 5, Case # 6, or Case # 7 the depository bank may have failed to exercise ordinary care when it allowed the employee to open an account in the name "Supplier Co.," to deposit checks payable to "Supplier Co." in that account, or to withdraw funds from that account that were proceeds of checks payable to Supplier Co. Failure to exercise ordinary care is to be determined in the context of all the facts relating to the bank's conduct with respect to the bank's collection of the check. If the trier of fact finds that there was such a failure and that the failure substantially contributed to loss, it could find the depository bank liable to the extent the failure contributed to the loss. The last sentence of subsection (b) (A.C.A. § 4-3-405(b)) can be illustrated by an example. Suppose in Case # 5 that the check is not payable to an obscure "Supplier Co." but rather to a well-known national corporation. In addition, the check is for a very large amount of money. Before depositing the check, Employee opens an account in Depository Bank in the name of the corporation and states to the person conducting the transaction for the bank



that Employee is manager of a new office being opened by the corporation. Depository Bank opens the account without requiring Employee to produce any resolutions of the corporation's board of directors or other evidence of authorization of Employee to act for the corporation. A few days later, the check is deposited, the account is credited, and the check is presented for payment. After Depository Bank receives payment, it allows Em-

ployee to withdraw the credit by a wire transfer to an account in a bank in a foreign country. The trier of fact could find that Depository Bank did not exercise ordinary care and that the failure to exercise ordinary care contributed to the loss suffered by Employer. The trier of fact could allow recovery by Employer from Depository Bank for all or part of the loss suffered by Employer.

### Comment to § 3-406 (A.C.A. § 4-3-406)\*

1. Section 3-406(a) (A.C.A. § 4-3-406(a)) is based on former Section 3-406. With respect to alteration, Section 3-406 (A.C.A. § 4-3-406) adopts the doctrine of *Young v. Grote*, 4 Bing. 253 (1827), which held that a drawer who so negligently draws an instrument as to facilitate its material alteration is liable to a drawee who pays the altered instrument in good faith. Under Section 3-406 (A.C.A. § 4-3-406) the doctrine is expanded to apply not only to drafts but to all instruments. It includes in the protected class any "person who, in good faith, pays the instrument or takes it for value or for collection." Section 3-406 (A.C.A. § 4-3-406) rejects decisions holding that the maker of a note owes no duty of care to the holder because at the time the instrument is issued there is no contract between them. By issuing the instrument and "setting it afloat upon a sea of strangers" the maker or drawer voluntarily enters into a relation with later holders which justifies imposition of a duty of care. In this respect an instrument so negligently drawn as to facilitate alteration does not differ in principle from an instrument containing blanks which may be filled. Under Section 3-407 (A.C.A. § 4-3-407) a person paying an altered instrument or taking it for value, in good faith and without notice of the alteration may enforce rights with respect to the instrument according to its original terms. If negligence of the obligor substantially contributes to an alteration, this section gives the holder or the payor the alternative right to treat the altered instrument as though it had been issued in the altered form.

No attempt is made to define particular conduct that will constitute "failure to exercise ordinary care [that] substantially

contributes to an alteration." Rather, "ordinary care" is defined in Section 3-103(a)(7) (A.C.A. § 4-3-103(a)(7)) in general terms. The question is left to the court or the jury for decision in the light of the circumstances in the particular case including reasonable commercial standards that may apply.

Section 3-406 (A.C.A. § 4-3-406) does not make the negligent party liable in tort for damages resulting from the alteration. If the negligent party is estopped from asserting the alteration the person taking the instrument is fully protected because the taker can treat the instrument as having been issued in the altered form.

2. Section 3-406 (A.C.A. § 4-3-406) applies equally to a failure to exercise ordinary care that substantially contributes to the making of a forged signature on an instrument. Section 3-406 (A.C.A. § 4-3-406) refers to "forged signature" rather than "unauthorized signature" that appeared in former Section 3-406 because it more accurately describes the scope of the provision. Unauthorized signature is a broader concept that includes not only forgery but also the signature of an agent which does not bind the principal under the law of agency. The agency cases are resolved independently under agency law. Section 3-406 (A.C.A. § 4-3-406) is not necessary in those cases.

The "substantially contributes" test of former Section 3-406 is continued in this section in preference to a "direct and proximate cause" test. The "substantially contributes" test is meant to be less stringent than a "direct and proximate cause" test. Under the less stringent test the preclusion should be easier to establish. Conduct "substantially contributes" to a material alteration or forged signature if it is a

contributing cause of the alteration or signature and a substantial factor in bringing it about. The analysis of "substantially contributes" in former Section 3-406 by the court in *Thompson Maple Products v. Citizens National Bank of Corry*, 234 A.2d 32 (Pa.Super.Ct.1967), states what is intended by the use of the same words in revised Section 3-406(b) (A.C.A. § 4-3-406(b)). Since Section 3-404(d) and Section 3-405(b) (A.C.A. §§ 4-3-404(d) and 4-3-405(b)) also use the words "substantially contributes" the analysis of these words also applies to those provisions.

3. The following cases illustrate the kind of conduct that can be the basis of a preclusion under Section 3-406(a) (A.C.A. § 4-3-406(a)):

*Case # 1.* Employer signs checks drawn on Employer's account by use of a rubber stamp of Employer's signature. Employer keeps the rubber stamp along with the Employer's personalized blank check forms in an unlocked desk drawer. An unauthorized person fraudulently uses the check forms to write checks on Employer's account. The checks are signed by use of the rubber stamp. If Employer demands that Employer's account in the drawee bank be recredited because the forged check was not properly payable, the drawee bank may defend by asserting that Employer is precluded from asserting the forgery. The trier of fact could find that Employer failed to exercise ordinary care to safeguard the rubber stamp and the check forms and that the failure substantially contributed to the forgery of Employer's signature by the unauthorized use of the rubber stamp.

*Case # 2.* An insurance company draws a check to the order of Sarah Smith in payment of a claim of a policyholder, Sarah Smith, who lives in Alabama. The insurance company also has a policyholder with the same name who lives in Illinois. By mistake, the insurance company mails the check to the Illinois Sarah Smith who indorses the check and obtains payment. Because the payee of the check is the Alabama Sarah Smith, the indorsement by the Illinois Sarah Smith is a forged instrument. Section

3-110(a) (A.C.A. § 4-3-110(a)). The trier of fact could find that the insurance company failed to exercise ordinary care when it mailed the check to the wrong person and that the failure substantially contributed to the making of the forged indorsement. In that event the insurance company could be precluded from asserting the forged indorsement against the drawee bank that honored the check.

*Case # 3.* A company writes a check for \$10. The figure "10" and the word "ten" are typewritten in the appropriate spaces on the check form. A large blank space is left after the figure and the word. The payee of the check, using a typewriter with a typeface similar to that used on the check, writes the word "thousand" after the word "ten" and a comma and three zeros after the figure "10". The drawee bank in good faith pays \$10,000 when the check is presented for payment and debits the account of the drawer in that amount. The trier of fact could find that the drawer failed to exercise ordinary care in writing the check and that the failure substantially contributed to the alteration. In that case the drawer is precluded from asserting the alteration against the drawee if the check was paid in good faith.

4. Subsection (b) (A.C.A. § 4-3-406(b)) differs from former Section 3-406 in that it adopts a concept of comparative negligence. If the person precluded under subsection (a) (A.C.A. § 4-3-406(a)) proves that the person asserting the preclusion failed to exercise ordinary care and that failure substantially contributed to the loss, the loss may be allocated between the two parties on a comparative negligence basis. In the case of a forged indorsement the litigation is usually between the payee of the check and the depository bank that took the check for collection. An example is a case like *Case # 1* of Comment 3 to Section 3-405 (A.C.A. § 4-3-405). If the trier of fact finds that Employer failed to exercise ordinary care in safeguarding the check and that the failure substantially contributed to the making of the forged indorsement, subsection (a) of Section 3-406 (A.C.A. § 4-3-406(a)) applies. If Employer brings an action for conversion against the depository bank that took the



checks from the forger, the depository bank could assert the preclusion under subsection (a) (A.C.A. § 4-3-406(a)). But suppose the forger opened an account in the depository bank in a name identical to that of Employer, the payee of the check, and then deposited the check in the account. Subsection (b) (A.C.A. § 4-3-406(b)) may apply. There may be an issue whether the depository bank should have been alerted to possible fraud when a new account was opened for a corporation shortly before a very large check payable to a payee with the same name is deposited. Circumstances surrounding the opening of the account may have sug-

gested that the corporation to which the check was payable may not be the same as the corporation for which the account was opened. If the trier of fact finds that collecting the check under these circumstances was a failure to exercise ordinary care, it could allocate the loss between the depository bank and Employer, the payee.

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\*This section was amended by Acts 1987, No. 564, § 1, making this section vary from the Uniform Commercial Code section by adding subsection (2). The original Uniform Commercial Code section is now subsection (1) in the Arkansas version.

### Comment to § 3-407 (A.C.A. § 4-3-407)

1. This provision restates former Section 3-407. Former Section 3-407 defined a "material" alteration as any alteration that changes the contract of the parties in any respect. Revised Section 3-407 refers to such a change as an alteration. As under subsection (2) of former Section 3-407, discharged because of alteration occurs only in the case of an alteration fraudulently made. There is no discharge if a blank is filled in the honest belief that it is authorized or if a change is made with a benevolent motive such as a desire to give the obligor the benefit of a lower interest rate. Changes favorable to the obligor are unlikely to be made with any fraudulent intent, but if such an intent is found the alteration may operate as a discharge.

Discharge is a personal defense of the party whose obligation is modified and anyone whose obligation is not affected is not discharged. But if an alteration discharges a party there is also discharge of any party having a right of recourse against the discharged party because the obligation of the party with the right of recourse is affected by the alteration. Assent to the alteration given before or after

it is made will prevent the party from asserting the discharge. The phrase "or is precluded from asserting the alteration" in subsection (b) (A.C.A. § 4-3-407(b)) recognizes the possibility of an estoppel or other ground barring the defense which does not rest on assent.

2. Under subsection (c) (A.C.A. § 4-3-407(c)) a person paying a fraudulently altered instrument or taking it for value, in good faith and without notice of the alteration, is not affected by a discharge under subsection (b) (A.C.A. § 4-3-407(b)). The person paying or taking the instrument may assert rights with respect to the instrument according to its original terms or, in the case of an incomplete instrument that is altered by unauthorized completion, according to its terms as completed. If blanks are filled or an incomplete instrument is otherwise completed, subsection (c) (A.C.A. § 4-3-407(c)) places the loss upon the party who left the instrument incomplete by permitting enforcement in its completed form. This result is intended even though the instrument was stolen from the issuer and completed after the theft.

### Comment to § 3-408 (A.C.A. § 4-3-408)

1. This section (A.C.A. § 4-3-408) is a restatement of former Section 3-409(1). Subsection (2) of former Section 3-409 is deleted as misleading and superfluous. Comment 3 says of subsection (2): "It is intended to make it clear that this section

does not in any way affect any liability which may arise apart from the instrument." In reality subsection (2) did not make anything clear and was a source of confusion. If all it meant was that a bank that has not certified a check may engage

in other conduct that might make it liable to a holder, it stated the obvious and was superfluous. Section 1-103 (A.C.A. § 4-1-103) is adequate to cover those cases.

2. Liability with respect to drafts may

arise under other law. For example, Section 4-302 (A.C.A. § 4-4-302) imposes liability on a payor bank for late return of an item.

### Comment to § 3-409 (A.C.A. § 4-3-409)

1. The first three subsections of Section 3-409 (A.C.A. § 4-3-409(a)-(c)) are a restatement of former Section 3-410. Subsection (d) (A.C.A. § 4-3-409(d)) adds a definition of certified check which is a type of accepted draft.

2. Subsection (a) (A.C.A. § 4-3-409(a)) states the generally recognized rule that the mere signature of the drawee on the instrument is a sufficient acceptance. Customarily the signature is written vertically across the face of the instrument, but since the drawee has no reason to sign for any other purpose a signature in any other place, even on the back of the instrument, is sufficient. It need not be accompanied by such words as "Accepted," "Certified," or "Good." It must not, however, bear any words indicating an intent to refuse to honor the draft. The last sentence of subsection (a) (A.C.A. § 4-3-409(a)) states the generally recognized rule that an acceptance written on the draft takes effect when the drawee notifies the holder or gives notice according to instructions.

3. The purpose of subsection (c) (A.C.A. § 4-3-409(c)) is to provide a definite date of payment if none appears on the instrument. An undated acceptance of a draft payable "thirty days after sight" is incomplete. Unless the acceptor writes in a different date the holder is authorized to complete the acceptance according to the terms of the draft by supplying a date of acceptance. Any date supplied by the holder is effective if made in good faith.

4. The last sentence of subsection (d) (A.C.A. § 4-3-409(d)) states the generally recognized rule that in the absence of agreement a bank is under no obligation to certify a check. A check is a demand instrument calling for payment rather than acceptance. The bank may be liable for breach of any agreement with the drawer, the holder, or any other person by which it undertakes to certify. Its liability is not on the instrument, since the drawee is not so liable until acceptance. Section 3-408 (A.C.A. § 4-3-408). Any liability is for breach of the separate agreement.

### Comment to § 3-410 (A.C.A. § 4-3-410)

1. This section (A.C.A. § 4-3-410) is a restatement of former Section 3-412. It applies to conditional acceptances, acceptances for part of the amount, acceptances to pay at a different time from that required by the draft, or to the acceptance of less than all of the drawees. It (A.C.A. § 4-3-410) applies to any other engagement changing the essential terms of the draft. If the drawee makes a varied acceptance the holder may either reject it or assent to it. The holder may reject by insisting on acceptance of the draft as presented. Refusal by the drawee to accept the draft as presented is dishonor. In that event the drawee is not bound by the varied acceptance and is entitled to have it canceled.

If the holder assents to the varied acceptance, the drawee's obligation as ac-

ceptor is according to the terms of the varied acceptance. Under subsection (c) (A.C.A. § 4-3-410(c)) the effect of the holder's assent is to discharge any drawer or indorser who does not also assent. The assent of the drawer or indorser must be affirmatively expressed. Mere failure to object within a reasonable time is not assent which will prevent the discharge.

2. Under subsection (b) (A.C.A. § 4-3-410(b)) an acceptance does not vary from the terms of the draft if it provides for payment at any particular bank or place in the United States unless the acceptance states that the draft is to be paid only at such bank or place. Section 3-501(b)(1) (A.C.A. § 4-3-501(b)(1)) states that if an instrument is payable at a bank in the United States presentment must be made at the place of payment (Section



3-111) (A.C.A. § 4-3-111) which in this case is at the designated bank.

### Comment to § 3-411 (A.C.A. § 4-3-411)

1. In some cases a creditor may require that the debt be paid by an obligation of a bank. The debtor may comply by obtaining certification of the debtor's check, but more frequently the debtor buys from a bank a cashier's check or teller's check payable to the creditor. The check is taken by the creditor as a cash equivalent on the assumption that the bank will pay the check. Sometimes, the debtor wants to retract payment by inducing the obligated bank not to pay. The typical case involves a dispute between the parties to the transaction in which the check is given in payment. In the case of a certified check or cashier's check, the bank can safely pay the holder of the check despite notice that there may be an adverse claim to the check (Section 3-602) (A.C.A. § 4-3-602). It is also clear that the bank that sells a teller's check has no duty to order the bank on which it is drawn not to pay it. A debtor using any of these types of checks has no right to stop payment. Nevertheless, some banks will refuse payment as an accommodation to a customer. Section 3-411 (A.C.A. § 4-3-411) is designed to discourage this practice.

2. The term "obligated bank" refers to the issuer of the cashier's check or teller's check and the acceptor of the certified check. If the obligated bank wrongfully refuses to pay, it is liable to pay for expenses and loss of interest resulting from the refusal to pay. There is no express provision for attorney's fees, but attorney's fees are not meant to be necessarily excluded. They could be granted because they fit within the language "expenses...resulting from the nonpayment." In addition the bank may be liable to pay consequential damages if it has

notice of the particular circumstances giving rise to the damages.

3. Subsection (c) (A.C.A. § 4-3-411(c)) provides that expenses or consequential damages are not recoverable if the refusal to pay is because of the reasons stated. The purpose is to limit that recovery to cases in which the bank refuses to pay even though its obligation to pay is clear and it is able to pay. Subsection (b) (A.C.A. § 4-3-411(b)) applies only if the refusal to honor the check is wrongful. If the bank is not obliged to pay there is no recovery. The bank may assert any claim or defense that it has, but normally the bank would not have a claim or defense. In the usual case it is a remitter that is asserting a claim to the check on the basis of a rescission of negotiation to the payee under Section 3-202 (A.C.A. § 4-3-202). See Comment 2 to Section 3-201 (A.C.A. § 4-3-201). The bank can assert that claim if there is compliance with Section 3-305(c) (A.C.A. § 4-3-305(c)), but the bank is not protected from damages under subsection (b) (A.C.A. § 4-3-411(b)) if the claim of the remitter is not upheld. In that case, the bank is insulated from damages only if payment is enjoined under Section 3-602(b)(1) (A.C.A. § 4-3-602(b)(1)). Subsection (c)(iii) (A.C.A. § 4-3-411(c)(iii)) refers to cases in which the bank may have a reasonable doubt about the identity of the person demanding payment. For example, a cashier's check is payable to "Supplier Co." The person in possession of the check claims to be an officer of Supplier Co. The bank may refuse payment until it has been given adequate proof that the presentment in fact is being made for Supplier Co., the person entitled to enforce the check.

### Comment to § 3-412 (A.C.A. § 4-3-412)

1. The obligations of the maker, acceptor, drawer, and indorser are stated in four separate sections. Section 3-412 (A.C.A. § 4-3-412) states the obligation of the maker of a note and is consistent with former Section 3-413(1). Section 3-412 (A.C.A. § 4-3-412) also applies to the is-

suer of a cashier's check or other draft drawn on the drawer. Under former Section 3-118(a), since a cashier's check or other draft drawn on the drawer was "effective as a note," the drawer was liable under former Section 3-413(1) as a maker. Under Sections 3-103(a)(6) and 3-104(f)

(A.C.A. §§ 4-3-103(a)(6) and 4-3-104(f)) a cashier's check or other draft drawn on the drawer is treated as a draft to reflect common commercial usage, but the liability of the drawer is stated by Section 3-412 (A.C.A. § 4-3-412) as being the same as that of the maker of a note rather than that of the drawer of a draft. Thus, Section 3-412 (A.C.A. § 4-3-412) does not in substance change former law.

2. Under Section 3-105(b) (A.C.A. § 4-3-105(b)) nonissuance of either a complete or incomplete instrument is a defense by a maker or drawer against a person that is not a holder in due course.

3. The obligation of the maker may be modified in the case of alteration if, under Section 3-406 (A.C.A. § 4-3-406), the maker is precluded from asserting the alteration.

### **Comment to § 3-413 (A.C.A. § 4-3-413)**

Subsection (a) (A.C.A. § 4-3-413(a)) is consistent with former Section 3-413(1). Subsection (b) (A.C.A. § 4-3-413(b)) has primary importance with respect to certified checks. It (A.C.A. § 4-3-413(b)) protects the holder in due course of a certified check that was altered after certification

and before negotiation to the holder in due course. A bank can avoid liability for the altered amount by stating on the check the amount the bank agrees to pay. The subsection applies to other accepted drafts as well.

### **Comment to § 3-414 (A.C.A. § 4-3-414)**

1. Subsection (a) (A.C.A. § 4-3-414(a)) excludes cashier's checks because the obligation of the issuer of a cashier's check is stated in Section 3-412 (A.C.A. § 4-3-412).

2. Subsection (b) (A.C.A. § 4-3-414(b)) states the obligation of the drawer on an unaccepted draft. It (A.C.A. § 4-3-414(b)) replaces former Section 3-413(2). The requirement under former Article 3 of notice of dishonor or protest has been eliminated. Under revised Article 3 (A.C.A. § 4-3-101 et seq.), notice of dishonor is necessary only with respect to indorser's liability. The liability of the drawer of an unaccepted draft is treated as a primary liability. Under former Section 3-102(1)(d) the term "secondary party" was used to refer to a drawer or indorser. The quoted term is not used in revised Article 3 (A.C.A. § 4-3-101 et seq.). The effect of a draft drawn without recourse is stated in subsection (e) (A.C.A. § 4-3-414(e)).

3. Under subsection (c) (A.C.A. § 4-3-414(c)) the drawer is discharged of liability on a draft accepted by a bank regardless of when acceptance was obtained. This changes former Section 3-411(1) which provided that the drawer is discharged only if the holder obtains acceptance. Holders that have a bank obligation do not normally rely on the drawer to guarantee the bank's solvency. A holder can obtain protection against the insolvency of a bank acceptor by a specific

guaranty of payment by the drawer or by obtaining an indorsement by the drawer. Section 3-205(d) (A.C.A. § 4-3-205(d)).

4. Subsection (d) (A.C.A. § 4-3-414(d)) states the liability of the drawer if a draft is accepted by a drawee other than a bank and the acceptor dishonors. The drawer of an unaccepted draft is the only party liable on the instrument. The drawee has no liability on the draft. Section 3-408 (A.C.A. § 4-3-408). When the draft is accepted, the obligations change. The drawee, as acceptor, becomes primarily liable and the drawer's liability is that of a person secondarily liable as a guarantor or payment. The drawer's liability is identical to that of an indorser, and subsection (d) (A.C.A. § 4-3-414(d)) states the drawer's liability that way. The drawer is liable to pay the person entitled to enforce the draft or any indorser that pays pursuant to Section 3-415 (A.C.A. § 4-3-415). The drawer in this case is discharged if notice of dishonor is required by Section 3-503 (A.C.A. § 4-3-503) and is not given in compliance with that section. A drawer that pays has a right of recourse against the acceptor. Section 3-413(a) (A.C.A. § 4-3-413(a)).

5. Subsection (e) (A.C.A. § 4-3-414(e)) does not permit the drawer of a check to avoid liability under subsection (b) (A.C.A. § 4-3-414(b)) by drawing the check without recourse. There is no legitimate pur-



pose served by issuing a check on which nobody is liable. Drawing without recourse is effective to disclaim liability of the drawer if the draft is not a check. Suppose, in a documentary sale, Seller draws a draft on Buyer for the price of goods shipped to Buyer. The draft is payable upon delivery to the drawee of an order bill of lading covering the goods. Seller delivers the draft with the bill of lading to Finance Company that is named as payee of the draft. If Seller draws without recourse Finance Company takes the risk that Buyer will dishonor. If Buyer dishonors, Finance Company has no recourse against Seller but it can obtain reimbursement by selling the goods which it controls through the bill of lading.

6. Subsection (f) (A.C.A. § 4-3-414(f)) is derived from former Section 3-502(1)(b). It is designed to protect the drawer of a check against loss resulting from suspension of payments by the drawee bank when the holder of the check delays collection of the check. For example, X writes a check payable to Y for \$1,000. The check is covered by funds in X's account in the drawee bank. Y delays initiation of collection of the check for more than 30 days after the date of the check. The drawee bank suspends payments after the 30-day period and before the check is presented for payment. If the \$1,000 of funds in X's account have not been withdrawn, X has a claim for those funds against the drawee

bank and, if subsection (e) (A.C.A. § 4-3-414(e)) were not in effect, X would be liable to Y on the check because the check was dishonored. Section 3-502(e) (A.C.A. § 4-3-502(e)). If the suspension of payments by the drawee bank will result in payment to X of less than the full amount of the \$1,000 in the account or if there is a significant delay in payment to X, X will suffer a loss which would not have been suffered if Y had promptly initiated collection of the check. In most cases, X will not suffer any loss because of the existence of federal bank deposit insurance that covers accounts up to \$100,000. Thus, subsection (e) (A.C.A. § 4-3-414(e)) has relatively little importance. There might be some cases, however, in which the account is not fully insured because it exceeds \$100,000 or because the account doesn't qualify for deposit insurance. Subsection (f) (A.C.A. § 4-3-414(f)) retains the phrase "deprived of funds maintained with the drawee" appearing in former Section 3-502(1)(b). The quoted phrase applies if the suspension of payments by the drawee prevents the drawer from receiving the benefit of funds which would have paid the check if the holder had been timely in initiating collection. Thus, any significant delay in obtaining full payment of the funds is a deprivation of funds. The drawer can discharge drawer's liability by assigning rights against the drawee with respect to the funds to the holder.

### Comment to § 3-415 (A.C.A. § 4-3-415)

1. Subsections (a) and (b) (A.C.A. § 4-3-415(a) and (b)) restate the substance of former Section 3-414(1). Subsection (2) of former Section 3-414 has been dropped because it is superfluous. Although notice of dishonor is not mentioned in subsection (a) (A.C.A. § 4-3-415(a)), it must be given in some cases to charge an indorser. It is covered in subsection (c) (A.C.A. § 4-3-415(c)). Regulation CC § 229.35(b) provides that a bank handling a check for collection or return is liable to a bank that subsequently handles the check to the extent the latter bank does not receive payment for the check. This liability applies whether or not the bank incurring the liability indorsed the check.

2. Section 3-503 (A.C.A. § 4-3-503) states when notice of dishonor is required and how it must be given. If required

notice of dishonor is not given in compliance with Section 3-503 (A.C.A. § 4-3-503), subsection (c) of Section 3-415 (A.C.A. § 4-3-415(c)) states that the effect is to discharge the indorser's obligation.

3. Subsection (d) (A.C.A. § 4-3-415(d)) is similar in effect to Section 3-414(c) (A.C.A. § 4-3-414(c)) if the draft is accepted by a bank after the indorsement is made. See Comment 3 to Section 3-414 (A.C.A. § 4-3-414). If a draft is accepted by a bank before the indorsement is made, the indorser incurs the obligation stated in subsection (a) (A.C.A. § 4-3-415(a)).

4. Subsection (e) (A.C.A. § 4-3-415(e)) modified former Sections 3-503(2)(b) and 3-502(1)(a) by stating a 30-day rather than a seven-day period, and stating it as an absolute rather than a presumptive period.

5. As stated in subsection (a) (A.C.A. § 4-3-415(a)) the obligation of an indorser to pay the amount due on the instrument is generally owed not only to a person entitled to enforce the instrument but also to a subsequent indorser who paid the instrument. But if the prior indorser and the subsequent indorser are both anomalous indorsers, this rule does not apply. In that case, Section 3-116 (A.C.A. § 4-3-116) applies. Under Section 3-116(a) (A.C.A. § 4-3-116(a)), the anomalous indorsers are jointly and severally liable and if either pays the instrument the indorser who pays has a right of contribution against the other. Section 3-116(b) (A.C.A. § 4-3-116(b)). The right to contribution in Section 3-116(b) (A.C.A. § 4-3-116(b)) is subject to "agreement of the affected par-

ties." Suppose the subsequent indorser can prove an agreement with the prior indorser under which the prior indorser agreed to treat the subsequent indorser as a guarantor of the obligation of the prior indorser. Rights of the two indorsers between themselves would be governed by the agreement. Under suretyship law, the subsequent indorser under such an agreement is referred to as a sub-surety. Under the agreement, if the subsequent indorser pays the instrument there is a right to reimbursement from the prior indorser; if the prior indorser pays the instrument, there is no right of recourse against the subsequent indorser. See PEB Commentary No. 11, dated February 10, 1994 [Appendix II at end of Volume 3b].

### Comment to § 3-416 (A.C.A. § 4-3-416)

1. Subsection (a) (A.C.A. § 4-3-416(a)) is taken from subsection (2) of former Section 3-417. Subsections (3) and (4) of former Section 3-417 are deleted. Warranties under subsection (a) (A.C.A. § 4-3-416(a)) in favor of the immediate transferee apply to all persons who transfer an instrument for consideration whether or not the transfer is accompanied by indorsement. Any consideration sufficient to support a simple contract will support those warranties. If there is an indorsement the warranty runs with the instrument and the remote holder may sue the indorser-warrantor directly and thus avoid a multiplicity of suits.

2. Since the purpose of transfer (Section 3-203(a)) (A.C.A. § 4-3-203(a)) is to give the transferee the right to enforce the instrument, subsection (a)(1) (A.C.A. § 4-3-416(a)(1)) is a warranty that the transferor is a person entitled to enforce the instrument (Section 3-301) (A.C.A. § 4-3-301). Under Section 3-203(b) (A.C.A. § 4-3-203(b)) transfer gives the transferee any right of the transferor to enforce the instrument. Subsection (a)(1) (A.C.A. § 4-3-416(a)(1)) is in effect a warranty that there are no unauthorized or missing indorsements that prevent the transferor from making the transferee a person entitled to enforce the instrument.

3. The rationale of subsection (a)(4) (A.C.A. § 4-3-416(a)(4)) is that the transferee does not undertake to buy an instru-

ment that is not enforceable in whole or in part, unless there is a contrary agreement. Even if the transferee takes as a holder in due course who takes free of the defense or claim in recoupment, the warranty gives the transferee the option of proceeding against the transferor rather than litigating with the obligor on the instrument the issue of the holder-in-due-course status of the transferee. Subsection (3) of former Section 3-417 which limits this warranty is deleted. The rationale is that while the purpose of a "no recourse" indorsement is to avoid a guaranty of payment, the indorsement does not clearly indicate an intent to disclaim warranties.

4. Under subsection (a)(5) (A.C.A. § 4-3-416(a)(5)) the transferor does not warrant against difficulties of collection, impairment of the credit of the obligor or even insolvency. The transferee is expected to determine such questions before taking the obligation. If insolvency proceedings as defined in Section 1-201(22) (A.C.A. § 4-1-201(22)) have been instituted against the party who is expected to pay and the transferor knows it, the concealment of that fact amounts to a fraud upon the transferee, and the warranty against knowledge of such proceedings is provided accordingly.

5. Transfer warranties may be disclaimed with respect to any instrument except a check. Between the immediate



parties disclaimer may be made by agreement. In the case of an indorser, disclaimer of transferor's liability, to be effective, must appear in the indorsement with words such as "without warranties" or some other specific reference to warranties. But in the case of a check, subsection (c) of Section 3-416 (A.C.A. § 4-3-416(c)) provides that transfer warranties cannot be disclaimed at all. In the check collection process the banking system relies on these warranties.

6. Subsection (b) (A.C.A. § 4-3-416(b)) states the measure of damages for breach of warranty. There is no express provision

for attorney's fees, but attorney's fees are not meant to be necessarily excluded. They could be granted because they fit within the phrase "expenses...incurred as a result of the breach." The intention is to leave to other state law the issue as to when attorney's fees are recoverable.

7. Since the traditional term "cause of action" may have been replaced in some states by "claim for relief" or some equivalent term, the words "cause of action" in subsection (d) (A.C.A. § 4-3-416(d)) have been bracketed to indicate that the words may be replaced by an appropriate substitute to conform to local practice.

### Comment to § 3-417 (A.C.A. § 4-3-417)

1. This section (A.C.A. § 4-3-417) replaces subsection (1) of former Section 3-417. The former provision was difficult to understand because it purported to state in one subsection all warranties given to any person paying any instrument. The result was a provision replete with exceptions that could not be readily understood except after close scrutiny of the language. In revised Section 3-417 (A.C.A. § 4-3-417), presentment warranties made to drawees of uncertified checks and other unaccepted drafts are stated in subsection (a) (A.C.A. § 4-3-417(a)). All other presentment warranties are stated in subsection (d) (A.C.A. § 4-3-417(d)).

2. Subsection (a) (A.C.A. § 4-3-417(a)) states three warranties. Subsection (a)(1) (A.C.A. § 4-3-417(a)(1)) in effect is a warranty that there are no unauthorized or missing indorsements. "Person entitled to enforce" is defined in Section 3-301 (A.C.A. § 4-3-301). Subsection (a)(2) (A.C.A. § 4-3-417(a)(2)) is a warranty that there is no alteration. Subsection (a)(3) (A.C.A. § 4-3-417(a)(3)) is a warranty of no knowledge that there is a forged drawer's signature. Subsection (a) (A.C.A. § 4-3-417(a)) states that the warranties are made to the drawee and subsections (b) and (c) (A.C.A. § 4-3-417(b) and (c)) identify the drawee as the person entitled to recover for breach of warranty. There is no warranty made to the drawer under subsection (a) (A.C.A. § 4-3-417(a)) when presentment is made to the drawee. Warranty to the drawer is governed by subsection (d) (A.C.A. § 4-3-417(d)) and that applies only when presentment for payment is

made to the drawer with respect to a dishonored draft. In *Sun 'N Sand, Inc. v. United California Bank*, 582 P.2d 920 (Cal.1978), the court held that under former Section 3-417(1) a warranty was made to the drawer of a check when the check was presented to the drawee for payment. The result in that case is rejected.

3. Subsection (a)(1) (A.C.A. § 4-3-417(a)(1)) retains the rule that the drawee does not admit the authenticity of indorsements and subsection (a)(3) (A.C.A. § 4-3-417(a)(3)) retains the rule of *Price v. Neal*, 3 Burr. 1354 (1762), that the drawee takes the risk that the drawer's signature is unauthorized unless the person presenting the draft has knowledge that the drawer's signature is unauthorized. Under subsection (a)(3) (A.C.A. § 4-3-417(a)(3)) the warranty of no knowledge that the drawer's signature is unauthorized is also given by prior transferors of the draft.

4. Subsection (d) (A.C.A. § 4-3-417(d)) applies to presentment for payment in all cases not covered by subsection (a) (A.C.A. § 4-3-417(a)). It (A.C.A. § 4-3-417(d)) applies to presentment of notes and accepted drafts to any party obliged to pay the instrument, including an indorser, and to presentment of dishonored drafts if made to the drawer or an indorser. In cases covered by subsection (d) (A.C.A. § 4-3-417(d)), there is only one warranty and it is the same as that stated in subsection (a)(1) (A.C.A. § 4-3-417(a)(1)). There are no warranties comparable to subsections (a)(2) and (a)(3) (A.C.A. § 4-3-417(a)(2)

and (a)(3)) because they are appropriate only in the case of presentment to the drawee of an unaccepted draft. With respect to presentment of an accepted draft to the acceptor, there is no warranty with respect to alteration or knowledge that the signature of the drawer is unauthorized. Those warranties were made to the drawee when the draft was presented for acceptance (Section 3-417(a)(2) and (3)) (A.C.A. § 4-3-417(a)(2) and (3)) and breach of that warranty is a defense to the obligation of the drawee as acceptor to pay the draft. If the drawee pays the accepted draft the drawee may recover the payment from any warrantor who was in breach of warranty when the draft was accepted. Section 3-417(b) (A.C.A. § 4-3-417(b)). Thus, there is no necessity for these warranties to be repeated when the accepted draft is presented for payment. Former Section 3-417(b)(iii) and (c)(iii) are not included in revised Section 3-417 (A.C.A. § 4-3-417) because they are unnecessary. Former Section 3-417(c)(iv) is not included because it is also unnecessary. The acceptor should know what the terms of the draft were at the time acceptance was made.

If presentment is made to the drawer or maker, there is no necessity for a warranty concerning the signature of that person or with respect to alteration. If presentment is made to an indorser, the indorser had itself warranted authenticity of signatures and that the instrument was not altered. Section 3-416(a)(2) and (3) (A.C.A. § 4-3-416(a)(2) and (3)).

5. The measure of damages for breach of warranty under subsection (a) (A.C.A. § 4-3-417(a)) is stated in subsection (b) (A.C.A. § 4-3-417(b)). There is no express provision for attorney's fees, but attorney's fees are not meant to be necessarily

excluded. They could be granted because they fit within the language "expenses...resulting from the breach." Subsection (b) (A.C.A. § 4-3-417(b)) provides that the right of the drawee to recover for breach of warranty is not affected by a failure of the drawee to exercise ordinary care in paying the draft. This provision follows the result reached under former Article 3 in *Hartford Accident & Indemnity Co. v. First Pennsylvania Bank*, 859 F.2d 295 (3d Cir.1988).

6. Subsection (c) (A.C.A. § 4-3-417(c)) applies to checks and other unaccepted drafts. It gives to the warrantor the benefit of rights that the drawee has against the drawer under Section 3-404, 3-405, 3-406, or 4-406 (A.C.A. §§ 4-3-404, 4-3-405, 4-3-406, or 4-4-406). If the drawer's conduct contributed to a loss from forgery or alteration, the drawee should not be allowed to shift the loss from the drawer to the warrantor.

7. The first sentence of subsection (e) (A.C.A. § 4-3-417(e)) recognizes that checks are normally paid by automated means and that payor banks rely on warranties in making payment. Thus, it is not appropriate to allow disclaimer of warranties appearing on checks that normally will not be examined by the payor bank. The second sentence requires a breach of warranty claim to be asserted within 30 days after the drawee learns of the breach and the identity of the warrantor.

8. Since the traditional term "cause of action" may have been replaced in some states by "claim for relief" or some equivalent term, the words "cause of action" in subsection (f) (A.C.A. § 4-3-417(f)) have been bracketed to indicate that the words may be replaced by an appropriate substitute to conform to local practice.

### Comment to § 3-418 (A.C.A. § 4-3-418)

1. This section covers payment or acceptance by mistake and replaces former Section 3-418. Under former Article 3, the remedy of a drawee that paid or accepted a draft by mistake was based on the law of mistake and restitution, but that remedy was not specifically stated. It was provided by Section 1-103 (A.C.A. § 4-1-103). Former Section 3-418 was simply a limitation on the unstated remedy under the

law of mistake and restitution. Under revised Article 3 (A.C.A. § 4-3-101 et seq.), Section 3-418 specifically states the right of restitution in subsections (a) and (b) (A.C.A. § 4-3-418(a) and (b)). Subsection (a) (A.C.A. § 4-3-418(a)) allows restitution in the two most common cases in which the problem is presented: payment or acceptance of forged checks and checks on which the drawer has stopped pay-



ment. If the drawee acted under a mistaken belief that the check was not forged or had not been stopped, the drawee is entitled to recover the funds paid or to revoke the acceptance whether or not the drawee acted negligently. But in each case, by virtue of subsection (c) (A.C.A. § 4-3-418(c)), the drawee loses the remedy if the person receiving payment or acceptance was a person who took the check in good faith and for value or who in good faith changed position in reliance on the payment or acceptance. Subsections (a) and (c) (A.C.A. § 4-3-418(a) and (c)) are consistent with former Section 3-418 and the rule of *Price v. Neal*. The result in the two cases covered by subsection (a) (A.C.A. § 4-3-418(a)) is that the drawee in most cases will not have a remedy against the person paid because there is usually a person who took the check in good faith and for value or who in good faith changed position in reliance on the payment or acceptance.

2. If a check has been paid by mistake and the payee receiving payment did not give value for the check or did not change position in reliance on the payment, the drawee bank is entitled to recover the amount of the check under subsection (a) (A.C.A. § 4-3-418(a)) regardless of how the check was paid. The drawee bank normally pays a check by a credit to an account of the collecting bank that presents the check for payment. The payee of the check normally receives the payment by a credit to the payee's account in the depository bank. But in some cases the payee of the check may have received payment directly from the drawee bank by presenting the check for payment over the counter. In those cases the payee is entitled to receive cash, but the payee may prefer another form of payment such as a cashier's check or teller's check issued by the drawee bank. Suppose Seller contracted to sell goods to Buyer. The contract provided for immediate payment by Buyer and delivery of the goods 20 days after payment. Buyer paid by mailing a check for \$10,000 drawn on Bank payable to Seller. The next day Buyer gave a stop payment order to Bank with respect to the check Buyer had mailed to Seller. A few days later Seller presented Buyer's check to Bank for payment over the counter and requested a cashier's check as payment. Bank issued and delivered a cashier's

check for \$10,000 payable to Seller. The teller failed to discover Buyer's stop order. The next day Bank discovered the mistake and immediately advised Seller of the facts. Seller refused to return the cashier's check and did not deliver any goods to Buyer.

Under Section 4-215 (A.C.A. § 4-4-215), Buyer's check was paid by Bank at the time it delivered its cashier's check to Seller. See Comment 3 to Section 4-215 (A.C.A. § 4-4-215). Bank is obliged to pay the cashier's check and has no defense to that obligation. The cashier's check was issued for consideration because it was issued in payment of Buyer's check. Although Bank has no defense on its cashier's check, it may have a right to recover \$10,000, the amount of Buyer's check, from Seller under Section 3-418(a) (A.C.A. § 4-3-418(a)). Bank paid Buyer's check by mistake. Seller did not give value for Buyer's check because the promise to deliver goods to Buyer was never performed. Section 3-303(a)(1) (A.C.A. § 4-3-303(a)(1)). And, on these facts, Seller did not change position in reliance on the payment of Buyer's check. Thus, the first sentence of Section 3-418(c) (A.C.A. § 4-3-418(c)) does not apply and Seller is obliged to return \$10,000 to Bank. Bank is obliged to pay the cashier's check but it has a counterclaim against Seller based on its rights under Section 3-418(a) (A.C.A. § 4-3-418(a)). This claim can be asserted against Seller, but it cannot be asserted against some other person with rights of a holder in due course of the cashier's check. A person without rights of a holder in due course of the cashier's check would take subject to Bank's claim against Seller because it is a claim in recoupment. Section 3-305(a)(3) (A.C.A. § 4-3-305(a)(3)). If Bank recovers from Seller under § 3-418(a) (A.C.A. § 4-3-418(a)), the payment of Buyer's check is treated as unpaid and dishonored. Section 3-418(d) (A.C.A. § 4-3-418(d)). One consequence is that Seller may enforce Buyer's obligation as drawer to pay the check. Section 3-414 (A.C.A. § 4-3-414). Another consequence is that Seller's rights against Buyer on the contract of sale are also preserved. Under Section 3-310(b) (A.C.A. § 4-3-310(b)) Buyer's obligation to pay for the goods was suspended when Seller took Buyer's check and remains suspended until the check is either dishonored or paid. Under Section

3-310(b)(1) (A.C.A. § 4-3-310(b)(1)) the obligation is discharged when the check is paid. Since Section 3-418(d) (A.C.A. § 4-3-418(d)) treats Buyer's check as unpaid and dishonored, Buyer's obligation is not discharged and suspension of the obligation terminates. Under Section 3-310(b)(3) (A.C.A. § 4-3-310(b)(3)), Seller may enforce either the contract of sale or the check subject to defenses and claims of Buyer.

If Seller had released the goods to Buyer before learning about the stop order, Bank would have no recovery against Seller under Section 3-418(a) (A.C.A. § 4-3-418(a)) because Seller in that case gave value for Buyer's check. Section 3-418(c) (A.C.A. § 4-3-418(c)). In this case Bank's sole remedy is under Section 4-407 (A.C.A. § 4-4-407) by subrogation.

3. Subsection (b) (A.C.A. § 4-3-418(b)) covers cases of payment or acceptance by mistake that are not covered by subsection (a) (A.C.A. § 4-3-418(a)). It directs courts to deal with those cases under the law governing mistake and restitution. Perhaps the most important class of cases that falls under subsection (b) (A.C.A. § 4-3-418(b)), because it is not covered by subsection (a) (A.C.A. § 4-3-418(a)), is that of payment by the drawee bank of a check with respect to which the bank has no duty to the drawer to pay either because the drawer has no account with the bank or because available funds in the drawer's account are not sufficient to cover the amount of the check. With respect to such a case, under Restatement of Restitution § 29, if the bank paid because of a mistaken belief that there were available funds in the drawer's account sufficient to cover the amount of the check, the bank is entitled to restitution. But § 29 is subject to Restatement of Restitution § 33 which denies restitution if the holder of the check receiving payment paid value in good faith for the check and had no reason to know that the check was paid by mistake when payment was received.

The result in some cases is clear. For example, suppose Father gives Daughter a check for \$10,000 as a birthday gift. The check is drawn on Bank in which both

Father and Daughter have accounts. Daughter deposits the check in her account in Bank. An employee of Bank, acting under the belief that there were available funds in Father's account to cover the check, caused Daughter's account to be credited for \$10,000. In fact, Father's account was overdrawn and Father did not have overdraft privileges. Since Daughter received the check gratuitously there is clear unjust enrichment if she is allowed to keep the \$10,000 and Bank is unable to obtain reimbursement from Father. Thus, Bank should be permitted to reverse the credit to Daughter's account. But this case is not typical. In most cases the remedy of restitution will not be available because the person receiving payment of the check will have given value for it in good faith.

In some cases, however, it may not be clear whether a drawee bank should have a right of restitution. For example, a check-kiting scheme may involve a large number of checks drawn on a number of different banks in which the drawer's credit balances are based on uncollected funds represented by fraudulently drawn checks. No attempt is made in Section 3-418 (A.C.A. § 4-3-418) to state rules for determining the conflicting claims of the various banks that may be victimized by such a scheme. Rather, such cases are better resolved on the basis of general principles of law and the particular facts presented in the litigation.

The right of the drawee to recover a payment or to revoke an acceptance under Section 3-418 (A.C.A. § 4-3-418) is not affected by the rules under Article 4 (A.C.A. § 4-4-101 et seq.) that determine when an item is paid. Even though a payor bank may have paid an item under Section 4-215 (A.C.A. § 4-4-215), it may have a right to recover the payment under Section 3-418 (A.C.A. § 4-3-418). *National Savings & Trust Co. v. Park Corp.*, 722 F.2d 1303 (6th Cir. 1983), cert. denied, 466 U.S. 939 (1984), correctly states the law on the issue under former Article 3. Revised Article 3 (A.C.A. § 4-3-101 et seq.) does not change the previous law.



**Comment to § 3-419 (A.C.A. § 4-3-419)**

1. Section 3-419 (A.C.A. § 4-3-419) replaces former Sections 3-415 and 3-416. An accommodation party is a person who signs an instrument to benefit the accommodated party either by signing at the time value is obtained by the accommodated party or later, and who is not a direct beneficiary of the value obtained. An accommodation party will usually be a co-maker or anomalous indorser. Subsection (a) (A.C.A. § 4-3-419(a)) distinguishes between direct and indirect benefit. For example, if X cosigns a note of Corporation that is given for a loan to Corporation, X is an accommodation party if no part of the loan was paid to X or for X's direct benefit. This is true even though X may receive indirect benefit from the loan because X is employed by Corporation or is a stockholder of Corporation, or even if X is the sole stockholder so long as Corporation and X are recognized as separate entities.

2. It does not matter whether an accommodation party signs gratuitously either at the time the instrument is issued or after the instrument is in the possession of a holder. Subsection (b) of Section 3-419 (A.C.A. § 4-3-419(b)) takes the view stated in Comment 3 to former Section 3-415 that there need be no consideration running to the accommodation party: "The obligation of the accommodation party is supported by any consideration for which the instrument is taken before it is due. Subsection (2) is intended to change occasional decisions holding that there is no sufficient consideration where an accommodation party signs a note after it is in the hands of a holder who has given value. The [accommodation] party is liable to the holder in such a case even though there is no extension of time or other concession."

3. As stated in Comment 1, whether a person is an accommodation party is a question of fact. But it is almost always the case that a co-maker who signs with words of guaranty after the signature is an accommodation party. The same is true of an anomalous indorser. In either case a person taking the instrument is put on notice of the accommodation status of the co-maker or indorser. This is relevant to

Section 3-605(h) (A.C.A. § 4-3-605(h)). But, under subsection (c) (A.C.A. § 4-3-419(c)), signing with words of guaranty or as an anomalous indorser also creates a presumption that the signer is an accommodation party. A party challenging accommodation party status would have to rebut this presumption by producing evidence that the signer was in fact a direct beneficiary of the value given for the instrument.

4. Subsection (b) (A.C.A. § 4-3-419(b)) states that an accommodation party is liable on the instrument in the capacity in which the party signed the instrument. In most cases that capacity will be either that of a maker or indorser of a note. But subsection (d) (A.C.A. § 4-3-419(d)) provides a limitation on subsection (b) (A.C.A. § 4-3-419(b)). If the signature of the accommodation party is accompanied by words indicating unambiguously that the party is guaranteeing collection rather than payment of the instrument, liability is limited to that stated in subsection (d) (A.C.A. § 4-3-419(d)), which is based on former Section 3-416(2).

Former Article 3 was confusing because the obligation of a guarantor was covered both in Section 3-415 and in Section 3-416. The latter section suggested that a signature accompanied by words of guaranty created an obligation distinct from that of an accommodation party. Revised Article 3 (A.C.A. § 4-3-101 et seq.) eliminates that confusion by stating in Section 3-419 (A.C.A. § 4-3-419) the obligation of a person who uses words of guaranty. Portions of former Section 3-416 are preserved. Former Section 3-416(2) is reflected in Section 3-419(d) (A.C.A. § 4-3-419(d)) and former Section 3-416(4) is reflected in Section 3-419(c) (A.C.A. § 4-3-419(c)).

5. Subsection (e) (A.C.A. § 4-3-419(e)) restates subsection (5) of present subsection 3-415 (A.C.A. § 4-3-415(5)). Since the accommodation party that pays the instrument is entitled to enforce the instrument against the accommodation party, the accommodation party also obtains rights to any security interest or other collateral that secures payment of the instrument.

**Comment to § 3-420 (A.C.A. § 4-3-420)**

1. Section 3-420 (A.C.A. § 4-3-420) is a modification of former Section 3-419. The first sentence of Section 3-420(a) (A.C.A. § 4-3-420(a)) states a general rule that the law of conversion applicable to personal property also applies to instruments. Paragraphs (a) and (b) of former Section 3-419(1) are deleted as inappropriate in cases of noncash items that may be delivered for acceptance or payment in collection letters that contain varying instructions as to what to do in the event of nonpayment on the day of delivery. It is better to allow such cases to be governed by the general law of conversion that would address the issue of when, under the circumstances prevailing, the presenter's right to possession has been denied. The second sentence of Section 3-420(a) (A.C.A. § 4-3-420(a)) states that an instrument is converted if it is taken by transfer other than a negotiation from a person not entitled to enforce the instrument or taken for collection or payment from a person not entitled to enforce the instrument or receive payment. This covers cases in which a depositary or payor bank takes an instrument bearing a forged indorsement. It also covers cases in which an instrument is payable to two persons and the persons are not alternative payees, e.g., a check payable to John and Jane Doe. Under Section 3-110(d) (A.C.A. § 4-3-110(d)) the check can be negotiated or enforced only by both persons acting jointly. Thus, neither payee acting without the consent of the other, is a person entitled to enforce the instrument. If John indorses the check and Jane does not, the indorsement is not effective to allow negotiation of the check. If Depositary Bank takes the check for deposit to John's account. Depositary Bank is liable to Jane for conversion of the check if she did not consent to the transaction. John, acting alone, is not the person entitled to enforce the check because John is not the holder of the check. Section 3-110(d) (A.C.A. § 4-3-110(d)) and Comment 4 to Section 3-110 (A.C.A. § 4-3-110). Depositary Bank does not get any greater rights under Section 4-205(1) (A.C.A. § 205(1)). If it acted for John as its customer, it did not become holder of the check under that provision because John, its customer, was not a holder.

Under former Article 3, the cases were divided on the issue of whether the drawer of a check with a forged indorsement can assert rights against a depositary bank that took the check. The last sentence of Section 3-420(a) (A.C.A. § 4-3-420(a)) resolves the conflict by following the rule stated in *Stone & Webster Engineering Corp. v. First National Bank & Trust Co.*, 184 N.E.2d 358 (Mass. 1962). There is no reason why a drawer should have an action in conversion. The check represents an obligation of the drawer rather than property of the drawer. The drawer has an adequate remedy against the payor bank for recredit of the drawer's account for unauthorized payment of the check.

There was also a split of authority under former Article 3 on the issue of whether a payee who never received the instrument is a proper plaintiff in a conversion action. The typical case was one in which a check was stolen from the drawer or in which the check was mailed to an address different from that of the payee and was stolen after it arrived at that address. The thief forged the indorsement of the payee and obtained payment by depositing the check to an account in a depositary bank. The issue was whether the payee could bring an action in conversion against the depositary bank or the drawee bank. In revised Article 3 (A.C.A. § 4-3-101 et seq.), under the last sentence of Section 3-420(a) (A.C.A. § 4-3-420(a)), the payee has no conversion action because the check was never delivered to the payee. Until delivery, the payee does not have any interest in the check. The payee never became the holder of the check nor a person entitled to enforce the check. Section 3-301 (A.C.A. § 4-3-301). Nor is the payee injured by the fraud. Normally the drawer of a check intends to pay an obligation owed to the payee. But if the check is never delivered to the payee, the obligation owed to the payee is not affected. If the check falls into the hands of a thief who obtains payment after forging the signature of the payee as an indorsement, the obligation owed to the payee continues to exist after the thief receives payment. Since the payee's right to enforce the underlying obligation is unaffected by the



fraud of the thief, there is no reason to give any additional remedy to the payee. The drawer of the check has no conversion remedy, but the drawee is not entitled to charge the drawer's account when the drawee wrongfully honored the check. The remedy of the drawee is against the depository bank for breach of warranty under Section 3-417(a)(1) or 4-208(a)(1) (A.C.A. §§ 4-3-417(a)(1) or 4-208(a)(1)). The loss will fall on the person who gave value to the thief for the check.

The situation is different if the check is delivered to the payee. If the check is taken for an obligation owed to the payee, the last sentence of Section 3-310(b)(4) (A.C.A. § 4-3-310(b)(4)) provides that the obligation may not be enforced to the extent of the amount of the check. The payee's rights are restricted to enforcement of the payee's rights in the instrument. In this event, the payee is injured by the theft and has a cause of action for conversion.

The payee receives delivery when the check comes in to the payee's possession, as for example when it is put into the payee's mailbox. Delivery to an agent is delivery to the payee. If a check is payable to more than one payee, delivery to one of the payees is deemed to be delivery to all of the payees. Occasionally, the person asserting a conversion cause of action is an indorsee rather than the original payee. If the check is stolen before the check can be delivered to the indorsee and the indorsee's indorsement is forged, the analysis is similar. For example, a check is payable to the order of A. A indorses it to B and puts it into an envelope addressed to B. The envelope is never delivered to B. Rather, Thief steals the envelope, forges B's indorsement to the check and obtains payment. Because the check was never delivered to B, the indorsee, B has no cause of action for conversion, but A does have such an action. A is the owner of the check. B never obtained rights in the check. If A intended to negotiate the check to B in payment of an obligation, that obligation was not affected by the conduct of Thief. B can enforce that obligation. Thief stole A's property not B's.

2. Subsection (2) of former Section 3-419 is amended because it is not clear why the former law distinguished between the liability of the drawee and that of other converters. Why should there be a

conclusive presumption that the liability is face amount if a drawee refuses to pay or return an instrument or makes payment on a forged indorsement, while the liability of a maker who does the same thing is only presumed to be the face amount? Moreover, it was not clear under former Section 3-419(2) what face amount meant. If a note for \$10,000 is payable in a year at 10% interest, it is common to refer to \$10,000 as the face amount, but if the note is converted the loss to the owner also includes the loss of interest. In revised Article 3 (A.C.A. § 4-3-101 et seq.), Section 3-420(b) (A.C.A. § 4-3-420(b)), by referring to "amount payable on the instrument," allows the full amount due under the instrument to be recovered.

The "but" clause in subsection (b) (A.C.A. § 4-3-420(b)) addresses the problem of conversion actions in multiple payee checks. Section 3-110(d) (A.C.A. § 4-3-110(d)) states that an instrument cannot be enforced unless all payees join in the action. But an action for conversion might be brought by a payee having no interest or a limited interest in the proceeds of the check. This clause prevents such a plaintiff from receiving a windfall. An example is a check payable to a building contractor and a supplier of building material. The check is not payable to the payees alternatively. Section 3-110(d) (A.C.A. § 4-3-110(d)). The check is delivered to the contractor by the owner of the building. Suppose the contractor forges supplier's signature as an indorsement of the check and receives the entire proceeds of the check. The supplier should not, without qualification, be able to recover the entire amount of the check from the bank that converted the check. Depending upon the contract between the contractor and the supplier, the amount of the check may be due entirely to the contractor, in which case there should be no recovery, entirely to the supplier, in which case recovery should be for the entire amount, or party may be due to one and the rest to the other, in which case recovery should be limited to the amount due to the supplier.

3. Subsection (3) of former Section 3-419 drew criticism from the courts, that saw no reason why a depository bank should have the defenses stated in the subsection. See *Knesz v. Central Jersey Bank & Trust Co.*, 477 A.2d 806

(N.J.1984). The depositary bank is ultimately liable in the case of a forged indorsement check because of its warranty to the payor bank under Section 4-208(a)(1) (A.C.A. § 4-4-208(a)(1)) and it is usually the most convenient defendant in cases involving multiple checks drawn on different banks. There is no basis for requiring the owner of the check to bring multiple actions against the various payor

banks and to require those banks to assert warranty rights against the depositary bank. In revised Article 3 (A.C.A. § 4-3-101 et seq.), the defense provided by Section 3-420(c) (A.C.A. § 4-3-420(c)) is limited to collecting banks other than the depositary bank. If suit is brought against both the payor bank and the depositary bank, the owner, of course is entitled to but one recovery.

#### **Comment to § 3-501 (A.C.A. § 4-3-501)**

Subsection (a) (A.C.A. § 4-3-501(a)) defines presentment. Subsection (b)(1) (A.C.A. § 4-3-501(b)(1)) states the place and manner of presentment. Electronic presentment is authorized. The communication of the demand for payment or acceptance is effective when received. Subsection (b)(2) (A.C.A. § 4-3-501(b)(2)) restates former Section 3-505. Subsection (b)(2)(i) (A.C.A. § 4-3-501(b)(2)(i)) allows the person to whom presentment is made

to require exhibition of the instrument, unless the parties have agreed otherwise as in an electronic presentment agreement. Former Section 3-507(3) is the antecedent of subsection (b)(3)(i) (A.C.A. § 4-3-501(b)(3)(i)). Since a payor must decide whether to pay or accept on the day of presentment, subsection (b)(4) (A.C.A. § 4-3-501(b)(4)) allows the payor to set a cut-off hour for receipt of instruments presented.

#### **Comment to § 3-502 (A.C.A. § 4-3-502)**

1. Section 3-415 (A.C.A. § 4-3-415) provides that an indorser is obliged to pay an instrument if the instrument is dishonored and is discharged if the indorser is entitled to notice of dishonor and notice is not given. Under Section 3-414 (A.C.A. § 4-3-414), the drawer is obliged to pay an unaccepted draft if it is dishonored. The drawer, however, is not entitled to notice of dishonor except to the extent required in a case governed by Section 3-414(d) (A.C.A. § 4-3-414(d)). Part 5 tells when an instrument is dishonored (Section 3-502) (A.C.A. § 4-3-502) and what it means to give notice of dishonor (Section 3-503) (A.C.A. § 4-3-503). Often dishonor does not occur until presentment (Section 3-501) (A.C.A. § 4-3-501), and frequently presentment and notice of dishonor are excused (Section 3-504) (A.C.A. § 4-3-504).

2. In the great majority of cases presentment and notice of dishonor are waived with respect to notes. In most cases a formal demand for payment to the maker of the note is not contemplated. Rather, the maker is expected to send payment to the holder of the note on the date or dates on which payment is due. If payment is not made when due, the holder

usually makes a demand for payment, but in the normal case in which presentment is waived, demand is irrelevant and the holder can proceed against indorsers when payment is not received. Under former Article 3, in the small minority of cases in which presentment and dishonor were not waived with respect to notes, the indorser was discharged from liability (former Section 3-502(1)(a)) unless the holder made presentment to the maker on the exact day the note was due (former Section 3-503(1)(c)) and gave notice of dishonor to the indorser before midnight of the third business day after dishonor (former Section 3-508(2)). These provisions are omitted from Revised Article 3 (A.C.A. § 4-3-101 et seq.) as inconsistent with practice which seldom involves face-to-face dealings.

3. Subsection (a) (A.C.A. § 4-3-502(a)) applies to notes. Subsection (a)(1) (A.C.A. § 4-3-502(a)(1)) applies to notes payable on demand. Dishonor requires presentment, and dishonor occurs if payment is not made on the day of presentment. There is no change from previous Article 3. Subsection (a)(2) (A.C.A. § 4-3-502(a)(2)) applies to notes payable at a definite time if the note is payable at or



through a bank or, by its terms, presentment is required. Dishonor requires presentment, and dishonor occurs if payment is not made on the due date or the day of presentment if presentment is made after the due date. Subsection (a)(3) (A.C.A. § 4-3-502(a)(3)) applies to all other notes. If the note is not paid on its due date it is dishonored. This allows holders to collect notes in ways that make sense commercially without having to be concerned about a formal presentment on a given day.

4. Subsection (b) (A.C.A. § 4-3-502(b)) applies to unaccepted drafts other than documentary drafts. Subsection (b)(1) (A.C.A. § 4-3-502(b)(1)) applies to checks. Except for checks presented for immediate payment over the counter, which are covered by subsection (b)(2) (A.C.A. § 4-3-502(b)(2)), dishonor occurs according to rules stated in Article 4 (A.C.A. § 4-4-101 et seq.). When a check is presented for payment through the check-collection system, the drawee bank normally makes settlement for the amount of the check to the presenting bank. Under Section 4-301 (A.C.A. § 4-4-301) the drawee bank may recover this settlement if it returns the check within its midnight deadline (Section 4-104) (A.C.A. § 4-4-104). In that case the check is not paid and dishonor occurs under Section 3-502(b)(1) (A.C.A. § 4-3-502(b)(1)). If the drawee bank does not return the check or give notice of dishonor or nonpayment within the midnight deadline, the settlement becomes final payment of the check. Section 4-215 (A.C.A. § 4-4-215). Thus, no dishonor occurs regardless of whether the check is retained or is returned after the midnight deadline. In some cases the drawee bank might not settle for the check when it is received. Under Section 4-302 (A.C.A. § 4-4-302) if the drawee bank is not also the depository bank and retains the check without settling for it beyond midnight of the day it is presented for payment, the bank becomes "accountable" for the amount of the check, i.e. it is obliged to pay the amount of the check. If the drawee bank is also the depository bank, the bank is accountable for the amount of the check if the bank does not pay the check or return it or send notice of dishonor within the midnight deadline. In all cases in which the drawee bank becomes accountable, the check has not been paid and,

under Section 3-502(b)(1) (A.C.A. § 4-3-502(b)(1)), the check is dishonored. The fact that the bank is obliged to pay the check does not mean that the check has been paid. When a check is presented for payment, the person presenting the check is entitled to payment not just the obligation of the drawee to pay. Until that payment is made, the check is dishonored. To say that the drawee bank is obliged to pay the check necessarily means that the check has not been paid. If the check is eventually paid, the drawee bank no longer is accountable.

Subsection (b)(2) (A.C.A. § 4-3-502(b)(2)) applies to demand drafts other than those governed by subsection (b)(1) (A.C.A. § 4-3-502(b)(1)). It covers checks presented for immediate payment over the counter and demand drafts other than checks. Dishonor occurs if presentment for payment is made and payment is not made on the day of presentment.

Subsection (b)(3) and (4) (A.C.A. § 4-3-502(b)(3) and (4)) applies to time drafts. An unaccepted time draft differs from a time note. The maker of a note knows that the note has been issued, but the drawee of a draft may not know that a draft has been drawn on it. Thus, with respect to drafts, presentment for payment or acceptance is required. Subsection (b)(3) (A.C.A. § 4-3-502(b)(3)) applies to drafts payable on a date stated in the draft. Dishonor occurs if presentment for payment is made and payment is not made on the day the draft becomes payable or the day of presentment if presentment is made after the due date. The holder of an unaccepted draft payable on a stated date has the option of presenting the draft for acceptance before the day the draft becomes payable to establish whether the drawee is willing to assume liability by accepting. Under subsection (b)(3)(ii) (A.C.A. § 4-3-502(b)(3)(ii)) dishonor occurs when the draft is presented and not accepted. Subsection (b)(4) (A.C.A. § 4-3-502(b)(4)) applies to unaccepted drafts payable on elapse of a period of time after sight or acceptance. If the draft is payable 30 days after sight, the draft must be presented for acceptance to start the running of the 30-day period. Dishonor occurs if it is not accepted. The rules in subsection (b)(3) and (4) (A.C.A. § 4-3-502(b)(3) and (4)) follow former Section 3-501(1)(a).

5. Subsection (c) (A.C.A. § 4-3-502(c))

gives drawees an extended period to pay documentary drafts because of the time that may be needed to examine the documents. The period prescribed is that given by Section 5-112 (A.C.A. § 4-5-112) in cases in which a letter of credit is involved.

6. Subsection (d) (A.C.A. § 4-3-502(d)) governs accepted drafts. If the acceptor's obligation is to pay on demand the rule, stated in subsection (d)(1) (A.C.A. § 4-3-502(d)(1)), is the same as for that of a demand note stated in subsection (a)(1) (A.C.A. § 4-3-502(a)(1)). If the acceptor's obligation is to pay at a definite time the rule, stated in subsection (d)(2) (A.C.A. § 4-3-502(d)(2)), is the same as that of a time note payable at a bank stated in subsection (b)(2) (A.C.A. § 4-3-502(b)(2)).

7. Subsection (e) (A.C.A. § 4-3-502(e)) is a limitation on subsection (a)(1) and (2), subsection (b), subsection (c), and subsec-

tion (d) (A.C.A. § 4-3-502(a)(1) and (2), (b), (c), and (d)). Each of those provisions states dishonor as occurring after presentment. If presentment is excused under Section 3-504 (A.C.A. § 4-3-504), dishonor occurs under those provisions without presentment if the instrument is not duly accepted or paid.

8. Under subsection (b)(3)(ii) and (4) (A.C.A. § 4-3-502(b)(3)(ii) and (4)) if a draft is presented for acceptance and the draft is not accepted on the day of presentment, there is dishonor. But after dishonor, the holder may consent to late acceptance. In that case, under subsection (f) (A.C.A. § 4-3-502(f)), the late acceptance cures the dishonor. The draft is treated as never having been dishonored. If the draft is subsequently presented for payment and payment is refused dishonor occurs at that time.

#### **Comment to § 3-503 (A.C.A. § 4-3-503)**

1. Subsection (a) (A.C.A. § 4-3-503(a)) is consistent with former Section 3-501(2)(a), but notice of dishonor is no longer relevant to the liability of a drawer except for the case of a draft accepted by an acceptor other than a bank. Comments 2 and 4 to Section 3-414 (A.C.A. § 4-3-414). There is no reason why drawers should be discharged on instruments they draw until payment or acceptance. They are entitled to have the instrument presented to the drawee and dishonored (Section 3-414(b)) (A.C.A. § 4-3-414(b)) before they are liable to pay, but no notice of

dishonor need be made to them as a condition of liability. Subsection (b) (A.C.A. § 4-3-503(b)), which states how notice of dishonor is given, is based on former Section 3-508(3).

2. Subsection (c) (A.C.A. § 4-3-503(c)) replaces former Section 3-508(2). It differs from that section in that it provides a 30-day period for a person other than a collecting bank to give notice of dishonor rather than the three-day period allowed in former Article 3. Delay in giving notice of dishonor may be excused under Section 3-504(c) (A.C.A. § 4-3-504(c)).

#### **Comment to § 3-504 (A.C.A. § 4-3-504)**

Section 3-504 (A.C.A. § 4-3-504) is largely a restatement of former Section 3-511. Subsection (4) of former Section

3-511 is replaced by Section 3-502(f) (A.C.A. § 4-3-502(f)).

#### **Comment to § 3-505 (A.C.A. § 4-3-505)**

Protest is no longer mandatory and must be requested by the holder. Even if requested, protest is not a condition to the liability of indorsers or drawers. Protest is a service provided by the banking system to establish that dishonor has occurred. Like other services provided by the banking system, it will be available if market

incentives, interbank agreements, or governmental regulations require it, but liabilities of parties no longer rest on it. Protest may be a requirement for liability on international drafts governed by foreign law which this Article (Chapter) (A.C.A. § 4-3-101 et seq.) cannot affect.



**Comment to § 3-601 (A.C.A. § 4-3-601)**

Subsection (a) (A.C.A. § 4-3-601(a)) replaces subsections (1) and (2) of former Section 3-601. Subsection (b) (A.C.A. § 4-3-601(b)) restates former Section 3-602. Notice of discharge is not treated as notice of a defense that prevents holder in due course status. Section 3-302(b) (A.C.A. § 4-3-302(b)). Discharge is effective against a holder in due course only if the

holder had notice of the discharge when holder in due course status was acquired. For example, if an instrument bearing a canceled indorsement is taken by a holder, the holder has notice that the indorser has been discharged. Thus, the discharge is effective against the holder even if the holder is a holder in due course.

**Comment to § 3-602 (A.C.A. § 4-3-602)**

This section (A.C.A. § 4-3-602) replaces former Section 3-603(1). The phrase "claim to the instrument" in subsection (a) (A.C.A. § 4-3-602(a)) means, by reference to Section 3-306 (A.C.A. § 4-3-306), a claim of ownership or possession and not a claim in recoupment. Subsection (b)(1)(ii) (A.C.A. § 4-3-602(b)(1)(ii)) is added to conform to Section 3-411 (A.C.A. § 4-3-411). Section 3-411 (A.C.A. § 4-3-411) is intended to discourage an obligated bank from refusing payment of a cashier's check, certified check or dishonored teller's check at the request of a claimant to the check who provided the bank with indemnity against loss. See Comment 1 to Section 3-411 (A.C.A. § 4-3-411). An obligated bank that refuses payment under those circumstances not only remains liable on the check but may also be liable to the holder of the check for consequential damages. Section 3-602(b)(1)(ii) (A.C.A. § 4-3-602(b)(1)(ii)) and Section 3-411

(A.C.A. § 4-3-411), read together, change the rule of former Section 3-603(1) with respect to the obligation of the obligated bank on the check. Payment to the holder of a cashier's check, teller's check, or certified check discharges the obligation of the obligated bank on the check to both the holder and the claimant even though indemnity has been given by the person asserting the claim. If the obligated bank pays the check is violation of an agreement with the claimant in connection with the indemnity agreement, any liability that the bank may have for violation of the agreement is not governed by Article 3 (A.C.A. § 4-3-101 et seq.), but is left to other law. This section (A.C.A. § 4-3-602) continues the rule that the obligor is not discharged on the instrument if payment is made in violation of an injunction against payment. See Section 3-411(c)(iv) (A.C.A. § 4-3-411(c)(iv)).

**Comment to § 3-603 (A.C.A. § 4-3-603)**

Section 3-603 (A.C.A. § 4-3-603) replaces former Section 3-604. Subsection (a) (A.C.A. § 4-3-603(a)) generally incorporates the law of tender of payment applicable to simple contracts. Subsections (b) and (c) (A.C.A. § 4-3-603(b) and (c)) state particular rules. Subsection (b) (A.C.A. § 4-3-603(b)) replaces former Sec-

tion 3-604(2). Under subsection (b) (A.C.A. § 4-3-603(b)) refusal of a tender of payment discharges any indorser or accommodation party having a right of recourse against the party making the tender. Subsection (c) (A.C.A. § 4-3-603(c)) replaces former Section 3-604(1) and (3).

**Comment to § 3-604 (A.C.A. § 4-3-604)**

Section 3-604 (A.C.A. § 4-3-604) replaces former Section 3-605.

**Comment to § 3-605 (A.C.A. § 4-3-605)**

1. Section 3-605 (A.C.A. § 4-3-605), which replaces former Section 3-606, can be illustrated by an example. Bank lends \$10,000 to Borrower who signs a note under which Borrower is obliged to pay \$10,000 to Bank on a due date stated in the note. Bank insists, however, that Accommodation Party also become liable to pay the note. Accommodation Party can incur this liability by signing the note as a co-maker or by indorsing the note. In either case the note is signed for accommodation and Borrower is the accommodated party. Rights and obligations of Accommodation Party in this case are stated in Section 3-419 (A.C.A. § 4-3-419). Suppose that after the note is signed, Bank agrees to a modification of the rights and obligations between Bank and Borrower. For example, Bank agrees that Borrower may pay the note at some date after the due date, or that Borrower may discharge Borrower's \$10,000 obligation to pay the note by paying Bank \$3,000, or that Bank releases collateral given by Borrower to secure the note. Under the law of suretyship Borrower is usually referred to as the principal debtor and Accommodation Party is referred to as the surety. Under that law, the surety can be discharged under certain circumstances if changes of this kind are made by Bank, the creditor, without the consent of Accommodation Party, the surety. Rights of the surety to discharge in such cases are commonly referred to as suretyship defenses. Section 3-605 (A.C.A. § 4-3-605) is concerned with this kind of problem in the context of a negotiable instrument to which the principal debtor and the surety are parties. But Section 3-605 (A.C.A. § 4-3-605) has a wider scope. It also applies to indorsers who are not accommodation parties. Unless an indorser signs without recourse, the indorser's liability under Section 3-415(a) (A.C.A. § 4-3-415(a)) is that of a guarantor of payment. If Bank in our hypothetical case indorsed the note and transferred it to Second Bank, Bank has rights given to an indorser under Section 3-605 (A.C.A. § 4-3-605) if it is Second Bank that modifies rights and obligations of Borrower. Both accommodation parties and indorsers will be referred to in these Comments as sureties. The scope of Sec-

tion 3-605 (A.C.A. § 4-3-605) is also widened by subsection (e) (A.C.A. § 4-3-605(e)) which deals with rights of a nonaccommodation party co-maker when collateral is impaired.

2. The importance of suretyship defenses is greatly diminished by the fact that they can be waived. The waiver is usually made by a provision in the note or other writing that represents the obligation of the principal debtor. It is standard practice to include a waiver of suretyship defenses in notes given to financial institutions or other commercial creditors. Section 3-605(i) (A.C.A. § 4-3-605(i)) allows waiver. Thus, Section 3-605 (A.C.A. § 4-3-605) applies to the occasional case in which the creditor did not include a waiver clause in the instrument or in which the creditor did not obtain the permission of the surety to take the action that triggers the suretyship defense.

3. Subsection (b) (A.C.A. § 4-3-605(b)) addresses the effect of discharge under Section 3-604 (A.C.A. § 4-3-604) of the principal debtor. In the hypothetical case stated in Comment 1, release of Borrower by Bank does not release Accommodation Party. As a practical matter, Bank will not gratuitously release Borrower. Discharge of Borrower normally would be part of a settlement with Borrower if Borrower is insolvent or in financial difficulty. If Borrower is unable to pay all creditors, it may be prudent for Bank to take partial payment, but Borrower will normally insist on a release of the obligation. If Bank takes \$3,000 and releases Borrower from the \$10,000 debt, Accommodation Party is not injured. To the extent of the payment Accommodation Party's obligation to Bank is reduced. The release of Borrower by Bank does not affect the right of Accommodation Party to obtain reimbursement from Borrower or to enforce the note against Borrower if Accommodation Party pays Bank. Section 3-419(e) (A.C.A. § 4-3-419(e)). Subsection (b) (A.C.A. § 4-3-605(b)) is designed to allow a creditor to settle with the principal debtor without risk of losing rights against sureties. Settlement is in the interest of sureties as well as the creditor. Subsection (b) (A.C.A. § 4-3-605(b)), however, is not intended to apply to a settlement of a disputed claim which discharges the obligation.



Subsection (b) (A.C.A. § 4-3-605(b)), changes the law stated in former Section 3-606 but the change relates largely to formalities rather than substance. Under former Section 3-606, Bank in the hypothetical case stated in Comment 1 could settle with and release Borrower without releasing Accommodation Party, but to accomplish that result Bank had to either obtain the consent of Accommodation Party or make an express reservation of rights against Accommodation Party at the time it released Borrower. The reservation of rights was made in the agreement between Bank and Borrower by which the release of Borrower was made. There was no requirement in former Section 3-606 that any notice be given to Accommodation Party. Section 3-605 (A.C.A. § 4-3-605) eliminates the necessity that Bank formally reserve rights against Accommodation Party in order to retain rights of recourse against Accommodation Party. See PEB Commentary No. 11, dated February 10, 1994 [Appendix II at end of Volume 3B].

4. Subsection (c) (A.C.A. § 4-3-605(c)) relates to extensions of the due date of the instrument. In most cases an extension of time to pay a note is a benefit to both the principal debtor and sureties having recourse against the principal debtor. In relatively few cases the extension may cause loss if deterioration of the financial condition of the principal debtor reduces the amount that the surety will be able to recover on its right of recourse when default occurs. Former Section 3-606(1)(a) did not take into account the presence or absence of loss to the surety. For example, suppose the instrument is an installment note and the principal debtor is temporarily short of funds to pay a monthly installment. The payee agrees to extend the due date of the installment for a month or two to allow the debtor to pay when funds are available. Under former Section 3-606 surety was discharged if consent was not given unless the payee expressly reserved rights against the surety. It did not matter that the extension of time was a trivial change in the guaranteed obligation and that there was no evidence that the surety suffered any loss because of the extension. *Wilmington Trust Co. v. Gesullo*, 29 U.C.C. Rep. 144 (Del.Super.Ct. 1980). Under subsection (c) (A.C.A. § 4-3-605(c)) an extension of time

results in discharge only to the extent the surety proves that the extension caused loss. For example, if the extension is for a long period the surety might be able to prove that during the period of extension the principal debtor became insolvent, thus reducing the value of the right of recourse of the surety. By putting the burden on the surety to prove loss, subsection (c) (A.C.A. § 4-3-605(c)) more accurately reflects what the parties would have done by agreement, and it facilitates workouts.

Under other provisions of Article 3 (A.C.A. § 4-3-101 et seq.), what is the effect of an extension agreement between the holder of a note and the maker who is an accommodated party? The question is illustrated by the following case:

*Case #1.* A borrows money from Lender and issues a note payable on April 1, 1992. B signs the note for accommodation at the request of Lender. B signed the note either as co-maker or as an anomalous indorser. In either case Lender subsequently makes an agreement with A extending the due date of A's obligation to pay the note to July 1, 1992. In either case B did not agree to the extension.

What is the effect of the extension agreement on B? Could Lender enforce the note against B if the note is not paid on April 1, 1992? A's obligation to Lender to pay the note on April 1, 1992 may be modified by the agreement of Lender. If B is an anomalous indorser Lender cannot enforce the note against B unless the note has been dishonored. Section 3-415(a) (A.C.A. § 4-3-415(a)). Under Section 3-502(a)(3) (A.C.A. § 4-3-502(a)(3)) dishonor occurs if it is not paid on the day it becomes payable. Since the agreement between A and Lender extended the due date of A's obligation to July 1, 1992 there is no dishonor because A was not obligated to pay Lender on April 1, 1992. If B is a co-maker the analysis is somewhat different. Lender has no power to amend the terms of the note without the consent of both A and B. By agreement with A, Lender can extend the due date of A's obligation to Lender to pay the note but B's obligation is to pay the note according to the terms of the note at the time of issue. Section 3-412 (A.C.A. § 4-3-412). However, B's obligation to pay the note is subject to a defense because B is an ac-

accommodation party. B is not obliged to pay Lender if A is not obliged to pay Lender. Under Section 3-305(d) (A.C.A. § 4-3-305(d)), B as an accommodation party can assert against Lender any defense of A. A has a defense based on the extension agreement. Thus, the result is that Lender could not enforce the note against B until July 1, 1992. This result is consistent with the right of B if B is an anomalous indorser.

As a practical matter an extension of the due date will normally occur when the accommodated party is unable to pay on the due date. The interest of the accommodation party normally is to defer payment to the holder rather than to pay right away and rely on an action against the accommodated party that may have little or no value. But in unusual cases the accommodation party may prefer to pay the holder on the original due date. In such cases, the accommodation party may do so. This is because the extension agreement between the accommodated party and the holder cannot bind the accommodation party to a change in its obligation without the accommodation party's consent. The effect on the recourse of the accommodation party against the accommodated party of performance by the accommodation party on the original due date is not addressed in § 3-419 (A.C.A. § 4-3-419) and is left to the general law of suretyship.

Even though an accommodation party has the option of paying the instrument on the original due date, the accommodation party is not precluded from asserting its rights to discharge under Section 3-605(c) (A.C.A. § 4-3-605(c)) if it does not exercise that option. The critical issue is whether the extension caused the accommodation party a loss by increasing the difference between its cost of performing its obligation on the instrument and the amount recoverable from the accommodated party pursuant to Section 3-419(e) (A.C.A. § 4-3-419(e)). The decision by the accommodation party not to exercise its option to pay on the original due date may, under the circumstances, be a factor to be considered in the determination of that issue. See PEB Commentary No. 11, *supra*.

5. Former Section 3-606 applied to extensions of the due date of a note but not to other modifications of the obligation of

the principal debtor. There was no apparent reason why former Section 3-606 did not follow general suretyship law in covering both. Under Section 3-605(d) (A.C.A. § 4-3-605(d)) a material modification of the obligation of the principal debtor, other than an extension of the due date, will result in discharge of the surety to the extent the modification caused loss to the surety with respect to the right of recourse. The loss caused by the modification is deemed to be the entire amount of the right of recourse unless the person seeking enforcement of the instrument proves that no loss occurred or that the loss was less than the full amount of the right of recourse. In the absence of that proof, the surety is completely discharged. The rationale for having different rules with respect to loss for extensions of the due date and other modifications is that extensions are likely to be beneficial to the surety and they are often made. Other modifications are less common and they may very well be detrimental to the surety. Modification of the obligation of the principal debtor without permission of the surety is unreasonable unless the modification is benign. Subsection (d) (A.C.A. § 4-3-605(d)) puts the burden on the person seeking enforcement of the instrument to prove the extent to which loss was not caused by the modification.

The following is an illustration of the kind of case to which Section 3-605(d) (A.C.A. § 4-3-605(d)) would apply:

*Case #2.* Corporation borrows money from Lender and issues a note payable to Lender. X signs the note as an accommodation party for Corporation. The loan agreement under which the note was issued states various events of default which allow Lender to accelerate the due date of the note. Among the events of default are breach of covenants not to incur debt beyond specified limits and not to engage in any line of business substantially different from that currently carried on by Corporation. Without consent of X, Lender agrees to modify the covenants to allow Corporation to enter into a new line of business that X considers to be risky, and to incur debt beyond the limits specified in the loan agreement to finance the new venture. This modification releases X unless Lender proves that the modification did not cause loss



to X or that the loss caused by the modification was less than X's right of recourse.

Sometimes there is both an extension of the due date and some other modification. In that case both subsections (c) and (d) (A.C.A. § 4-3-605(c) and (d)) apply. The following is an example:

*Case #3.* Corporation was indebted to Lender on a note payable on April 1, 1992 and X signed the note as an accommodation party for Corporation. The interest rate on the note was 12 percent. Lender and Corporation agreed to a six-month extension of the due date of the note to October 1, 1992 and an increase in the interest rate to 14 percent after April 1, 1992. Corporation defaulted on October 1, 1992. Corporation paid no interest during the six-month extension period. Corporation is insolvent and has no assets from which unsecured creditors can be paid. Lender demanded payment from X.

Assume X is an anomalous indorser. First consider Section 3-605(c) (A.C.A. § 4-3-605(c)) alone. If there had been no change in the interest rate, the fact that Lender gave an extension of six months to Corporation would not result in discharge unless X could prove loss with respect to the right of recourse because of the extension. If the financial condition of Corporation on April 1, 1992 would not have allowed any recovery on the right of recourse, X can't show any loss as a result of the extension with respect to the amount due on the note on April 1, 1992. Since the note accrued interest during the six-month extension, is there a loss equal to the accrued interest? Since the interest rate was not raised, only Section 3-605(c) (A.C.A. § 4-3-605(c)) would apply and X probably could not prove any loss. The obligation of X includes interest on the note until the note is paid. To the extent payment was delayed X had the use of the money that X otherwise would have had to pay to Lender. X could have prevented the running of interest by paying the debt. Since X did not do so, X suffered no loss as the result of the extension.

If the interest rate was raised, Section 3-605(d) (A.C.A. § 4-3-605(d)) also must be considered. If X is an anomalous indorser, X's liability is to pay the note according to its terms at the time of indorsement. Section 3-415(a) (A.C.A. § 4-

3-415(a)). Thus, X's obligation to pay interest is measured by the terms of the note (12%) rather than by the increased amount of 14 percent. The same analysis applies if X had been a co-maker. Under Section 3-412 (A.C.A. § 4-3-412) the liability of the issuer of a note is to pay the note according to its terms at the time it was issued. Either obligation could be changed by contract and that occurred with respect to Corporation when it agreed to the increase in the interest rate, but X did not join in that agreement and is not bound by it. Thus, the most that X can be required to pay is the amount due on the note plus interest at the rate of 12 percent.

Does the modification discharge X under Section 3-605(d) (A.C.A. § 4-3-605(d))? Any modification that increases the monetary obligation of X is material. An increase of the interest rate from 12 percent to 14 percent is certainly a material modification. There is a presumption that X is discharged because Section 3-605(d) (A.C.A. § 4-3-605(d)) creates a presumption that the modification caused a loss to X equal to the amount of the right of recourse. Thus, Lender has the burden of proving absence of loss or a loss less than the amount of the right of recourse. Since Corporation paid no interest during the six-month period, the issue is like the issue presented under Section 3-605(c) (A.C.A. § 4-3-605(c)) which we have just discussed. The increase in the interest rate could not have affected the right of recourse because no interest was paid by Corporation. X is in the same position as X would have been in if there had been an extension without an increase in the interest rate.

The analysis with respect to Section 3-605(c) and (d) (A.C.A. § 4-3-605(c) and (d)) would have been different if we change the assumptions. Suppose Corporation was not insolvent on April 1, 1992, that Corporation paid interest at the higher rate during the six-month period, and that Corporation was insolvent at the end of the six-month period. In this case it is possible that the extension and the additional burden placed on Corporation by the increased interest rate may have been detrimental to X.

There are difficulties in properly allocating burden of proof when the agreement between Lender and Corporation

involves both an extension under Section 3-605(c) (A.C.A. § 4-3-605(c)) and a modification under Section 3-605(d) (A.C.A. § 4-3-605(d)). The agreement may have caused loss to X but it may be difficult to identify the extent to which the loss was caused by the extension or the other modification. If neither Lender nor X introduces evidence on the issue, the result is full discharge because Section 3-605(d) (A.C.A. § 4-3-605(d)) applies. Thus, Lender has the burden of overcoming the presumption in Section 3-605(d) (A.C.A. § 4-3-605(d)). In doing so, Lender should be entitled to a presumption that the extension of time by itself caused no loss. Section 3-605(c) (A.C.A. § 4-3-605(c)) is based on such a presumption and X should be required to introduce evidence on the effect of the extension on the right of recourse. Lender would have to introduce evidence on the effect of the increased interest rate. Thus both sides will have to introduce evidence. On the basis of this evidence the court will have to make a determination of the overall effect of the agreement on X's right of recourse. See PEB Commentary No. 11, *supra*.

6. Subsection (e) (A.C.A. § 4-3-605(e)) deals with discharge of sureties by impairment of collateral. It generally conforms to former Section 3-606(1)(b). Subsection (g) (A.C.A. § 4-3-605(g)) states common examples of what is meant by impairment. By using the term "includes," it allows a court to find impairment in other cases as well. There is extensive case law on impairment of collateral. The surety is discharged to the extent the surety proves that impairment was caused by a person entitled to enforce the instrument. For example, suppose the payee of a secured note fails to perfect the security interest. The collateral is owned by the principal debtor who subsequently files in bankruptcy. As a result of the failure to perfect, the security interest is not enforceable in bankruptcy. If the payee obtains payment from the surety, the surety is subrogated to the payee's security interest in the collateral. In this case the value of the security interest is impaired completely because the security interest is unenforceable. If the value of the collateral is as much or more than the amount of the note there is a complete discharge.

In some states a real property grantee who assumes the obligation of the grantor

as maker of a note secured by the real property becomes by operation of law a principal debtor and the grantor becomes a surety. The meager case authority was split on whether former Section 3-606 applied to release the grantor if the holder released or extended the obligation of the grantee. Revised Article 3 (A.C.A. § 4-3-101 et seq.) takes no position on the effect of the release of the grantee in this case. Section 3-605(b) (A.C.A. § 4-3-605(b)) does not apply because the holder has not discharged the obligation of a "party," a term defined in Section 3-103(a)(8) (A.C.A. § 4-3-103(a)(8)) as "party to an instrument." The assuming grantee is not a party to the instrument. The resolution of this question is governed by general principles of law, including the law of suretyship. See PEB Commentary No. 11, *supra*.

7. Subsection (f) (A.C.A. § 4-3-605(f)) is illustrated by the following case. X and Y sign a note for \$1,000 as co-makers. Neither is an accommodation party. X grants a security interest in X's property to secure the note. The collateral is worth more than \$1,000. Payee fails to perfect the security interest in X's property before X files in bankruptcy. As a result the security interest is not enforceable in bankruptcy. Had Payee perfected the security interest, Y could have paid the note and gained rights to X's collateral by subrogation. If the security interest had been perfected, Y could have realized on the collateral to the extent of \$500 to satisfy its right of contribution against X. Payee's failure to perfect deprived Y of the benefit of the collateral. Subsection (f) (A.C.A. § 4-3-605(f)) discharges Y to the extent of its loss. If there are no assets in the bankruptcy for unsecured claims, the loss is \$500, the amount of Y's contribution claim against X which now has a zero value. If some amount is payable on unsecured claims, the loss is reduced by the amount receivable by Y. The same result follows if Y is an accommodation party but Payee has no knowledge of the accommodation or notice under Section 3-419(c) (A.C.A. § 4-3-419(c)). In that event Y is not discharged under subsection (e) (A.C.A. § 4-3-605(e)), but subsection (f) (A.C.A. § 4-3-605(f)) applies because X and Y are jointly and severally liable on the note. Under subsection (f) (A.C.A. § 4-3-605(f)), Y is treated as a co-maker with a right of contribution rather than an ac-



accommodation party with a right of reimbursement. Y is discharged to the extent of \$500. If Y is the principal debtor and X is the accommodation party subsection (f) (A.C.A. § 4-3-605(f)) doesn't apply. Y, as principal debtor, is not injured by the impairment of collateral because Y would have been obliged to reimburse X for the entire \$1,000 even if Payee had obtained payment from sale of the collateral.

8. Subsection (i) (A.C.A. § 4-3-605(i)) is a continuation of former law which allowed suretyship defenses to be waived. As the subsection provides, a party is not discharged under this section if the instrument or a separate agreement of the party waives discharge either specifically or by general language indicating that defenses based on suretyship and impairment of collateral are waived. No particular language or form of agreement is required, and the standards for enforcing such a term are the same as the standards for enforcing any other term in an instrument of agreement.

Subsection (i) (A.C.A. § 4-3-605(i)), however, applies only to a "discharge under this section." The right of an accommodation party to be discharged under Section 3-605(e) (A.C.A. § 4-3-605(e)) because of

an impairment of collateral can be waived. But with respect to a note secured by personal property collateral, Article 9 (A.C.A. § 4-9-101 et seq.) also applies. If an accommodation party is a "debtor" under Section 9-105(1)(d) (A.C.A. § 4-9-105(1)(d)), the accommodation party has rights under Article 9 (A.C.A. § 4-9-101 et seq.). Under Section 9-501(3)(b) (A.C.A. § 4-9-501(3)(b)) rights of an Article 9 (A.C.A. § 4-9-101 et seq.) debtor under Section 9-504(3) and Section 9-505(1) (A.C.A. §§ 4-9-504(3) and 4-9-505(1)), which deal with disposition of collateral cannot be waived except as provided in Article 9 (A.C.A. § 4-9-101 et seq.). These Article 9 (A.C.A. § 4-9-101 et seq.) rights are independent of rights under Section 3-605 (A.C.A. § 4-3-605). Since Section 3-605(i) (A.C.A. § 4-3-605(i)) is specifically limited to discharge under Section 3-605 (A.C.A. § 4-3-605), a waiver of rights with respect to Section 3-605 (A.C.A. § 4-3-605) has no effect on rights under Article 9 (A.C.A. § 4-9-101 et seq.). With respect to Article 9 (A.C.A. § 4-9-101 et seq.) rights, Section 9-501(3)(b) (A.C.A. § 9-501(3)(b)) controls. See PEB Commentary No. 11, *supra*.

## ARTICLE 4

### (A.C.A. § 4-4-101 ET SEQ.)\*

\*A revised Article 4 (A.C.A. § 4-4-101 et seq.) with conforming amendments to revised Article 3 (A.C.A. § 4-3-101 et seq.) and other miscellaneous amendments, was approved by the National Conference of Commissioners on Uniform State Laws in 1990. The General Assembly by Acts 1991, No. 572, § 6, enacted the amendments to Article 4 (A.C.A. § 4-4-101 et seq.).

#### Comment to § 4-101 (A.C.A. § 4-4-101)

1. The great number of checks handled by banks and the country-wide nature of the bank collection process require uniformity in the law of bank collections. There is needed a uniform statement of the principal rules of the bank collection process with ample provision for flexibility to meet the needs of the large volume handled and the changing needs and conditions that are bound to come with the years. This Article (Chapter) meets that need.

2. In 1950 at the time Article 4 was drafted, 6.7 billion checks were written annually. By the time of the 1990 revision of Article 4 (A.C.A. § 4-4-101 et seq.) annual volume was estimated by the American Bankers Association to be about 50 billion checks. The banking system could not have coped with this increase in check volume had it not developed in the late 1950s and early 1960s an automated system for check collection based on encoding checks with machine-readable information by Magnetic Ink Character Recognition (MICR). An important goal of the 1990 revision of Article 4 (A.C.A. § 4-4-101 et seq.) is to promote the efficiency of the check collection process by making the provisions of Article 4 (A.C.A. § 4-4-101 et seq.) more compatible with the needs of an automated system and, by doing so, increase the speed and lower the cost of check collection for those who write and receive checks. An additional goal of the 1990 revision of Article 4 (A.C.A. § 4-4-101 et seq.) is to remove any statutory barriers in the Article (Chapter) (A.C.A. § 4-4-101 et seq.) to the ultimate adoption of programs allowing the presentment of checks to payor banks by electronic trans-

mission of information captured from the MICR line on the checks. The potential of these programs for saving the time and expense of transporting the huge volume of checks from depository to payor banks is evident.

3. Article 4 (A.C.A. § 4-4-101 et seq.) defines rights between parties with respect to bank deposits and collections. It is not a regulatory statute. It does not regulate the terms of the bank-customer agreement, nor does it prescribe what constraints different jurisdictions may wish to impose on that relationship in the interest of consumer protection. The revisions in Article 4 (A.C.A. § 4-4-101 et seq.) are intended to create a legal framework that accommodates automation and truncation for the benefit of all bank customers. This may raise consumer problems which enacting jurisdictions may wish to address in individual legislation. For example, with respect to Section 4-401(c) (A.C.A. § 4-4-401(c)), jurisdictions may wish to examine their unfair and deceptive practices laws to determine whether they are adequate to protect drawers who postdate checks from unscrupulous practices that may arise on the part of persons who induce drawers to issue postdated checks in the erroneous belief that the checks will not be immediately payable. Another example arises from the fact that under various truncation plans customers will no longer receive their canceled checks and will no longer have the canceled check to prove payment. Individual legislation might provide that a copy of a bank statement along with a copy of the check is prima facie evidence of payment.



**Comment to § 4-102 (A.C.A. § 4-4-102)**

1. The rules of Article 3 (A.C.A. § 4-3-101 et seq.) governing negotiable instruments, their transfer, and the contracts of the parties thereto apply to the items collected through banking channels wherever no specific provision is found in this Article (Chapter) (A.C.A. § 4-4-101 et seq.). In the case of conflict, this Article (Chapter) (A.C.A. § 4-4-101 et seq.) governs. See Section 3-102(b) (A.C.A. § 4-3-102(b)).

Bonds and like instruments constituting investment securities under Article 8 (A.C.A. § 4-8-101 et seq.) may also be handled by banks for collection purposes. Various sections of Article 8 (A.C.A. § 4-8-101 et seq.) prescribe rules of transfer some of which (see Sections 8-304 and 8-306) (A.C.A. §§ 4-8-304 and 4-8-306) may conflict with provisions of this Article (Chapter) (A.C.A. § 4-4-101 et seq.) (Sections 4-205, 4-207, and 4-208) (A.C.A. §§ 4-4-205, 4-4-207, and 4-4-208). In the case of conflict, Article 8 (A.C.A. § 4-8-101 et seq.) governs.

Section 4-210 (A.C.A. § 4-4-210) deals specifically with overlapping problems and possible conflicts between this Article (Chapter) and Article 9 (A.C.A. § 4-9-101 et seq.). However, similar reconciling provisions are not necessary in the cases of Articles 5 and 7 (A.C.A. §§ 4-5-101 et seq. and 4-7-101 et seq.). Sections 4-301 and 4-302 (A.C.A. §§ 4-4-301 and 4-4-302) are consistent with Section 5-112 (A.C.A. § 4-5-112). In the case of Article 7 (A.C.A. § 4-7-101 et seq.) documents of title frequently accompany items but they are not themselves items. See Section 4-104(a)(9) (A.C.A. § 4-4-104(a)(9)).

In *Clearfield Trust Co. v. United States*, 318 U.S. 363 (1943), the Court held that if the United States is a party to an instrument, its rights and duties are governed by federal common law in the absence of a specific federal statute or regulation. In *United States v. Kimbell Foods, Inc.*, 440 U.S. 715 (1979), the Court stated a three-pronged test to ascertain whether the federal common-law rule should follow the state rule. In most instances courts under the *Kimbell* test have shown a willingness to adopt UCC rules in formulating federal common law on the subject. In *Kimbell* the Court adopted the priorities rules of Article 9 (A.C.A. § 4-9-101 et seq.).

In addition, applicable federal law may supersede provisions of this Article (Chapter) (A.C.A. § 4-4-101 et seq.). One federal law that does so is the Expedited Funds Availability Act, 12 U.S.C. § 4001 et seq., and its implementing Regulation CC, 12 CFR pt. 229. In some instances this law is alluded to in the statute, e.g., Section 4-215(e) and (f) (A.C.A. § 4-4-215(e) and (f)). In other instances, although not referred to in this Article (Chapter) (A.C.A. § 4-4-101 et seq.), the provisions of the EFAA and Regulation CC control with respect to checks. For example, except between the depository bank and its customer, all settlements are final and not provisional (Regulation CC, Section 229.36(d)), and the midnight deadline may be extended (Regulation CC, Section 229.30(c)). The comments to this Article (Chapter) (A.C.A. § 4-4-101 et seq.) suggest in most instances the relevant Regulation CC provisions.

2. Subsection (b) (A.C.A. § 4-4-102(b)) is designed to state a workable rule for the solution of otherwise vexatious problems of the conflicts of laws:

a. The routine and mechanical nature of bank collections make it imperative that one law govern the activities of one office of a bank. The requirement found in some cases that to hold an indorser notice must be given in accordance with the law of the place of indorsement, since that method of notice became an implied term of the indorser's contract, is more theoretical than practical.

b. Adoption of what is in essence a tort theory of the conflict of laws is consistent with the general theory of this Article (Chapter) (A.C.A. § 4-4-101 et seq.) that the basic duty of a collecting bank is one of good faith and the exercise of ordinary care. Justification lies in the fact that, in using an ambulatory instrument, the drawer, payee, and indorsers must know that action will be taken with respect to it in other jurisdictions. This is especially pertinent with respect to the law of the place of payment.

c. The phrase "action or non-action with respect to any item handled by it for purposes of presentment, payment, or collection" is intended to make the conflicts rule of subsection (b) (A.C.A. § 4-4-102(b))

apply from the inception of the collection process of an item through all phases of deposit, forwarding, presentment, payment and remittance or credit of proceeds. Specifically the subsection applies to the initial act of a depository bank in receiving an item and to the incidents of such receipt. The conflicts rule of *Weissman v. Banque de Bruxelles*, 254 N.Y. 488, 173 N.E. 835 (1930), is rejected. The subsection (A.C.A. § 4-4-102(b)) applies to questions of possible vicarious liability of a bank for action or non-action of sub-agents (see Section 4-202(c)) (A.C.A. § 4-4-202(c)), and tests these questions by the law of the state of the location of the bank which uses the sub-agent. The conflicts rule of *St. Nicholas Bank of New York v. State Nat. Bank*, 128 N.Y. 26, 27 N.E. 849, 13 L.R.A. 241 (1891), is rejected. The subsection (A.C.A. § 4-4-102(b)) applies to action or non-action of a payor bank in

connection with handling an item (see Sections 4-215(a), 4-301, 4-302, 4-303) (A.C.A. §§ 4-4-215(a), 4-4-301, 4-4-302, and 4-4-303) as well as action or non-action of a collecting bank (Sections 4-201 through 4-216) (A.C.A. §§ 4-4-201 — 4-4-216); to action or non-action of a bank which suspends payment or is affected by another bank suspending payment (Section 4-216) (A.C.A. § 4-4-216); to action or non-action of a bank with respect to an item under the rule of Part 4 of Article 4 (A.C.A. § 4-4-401 et seq.).

d. In a case in which subsection (b) (A.C.A. § 4-4-102(b)) makes this Article (Chapter) applicable, Section 4-103(a) (A.C.A. § 4-4-103(a)) leaves open the possibility of an agreement with respect to applicable law. This freedom of agreement follows the general policy of Section 1-105 (A.C.A. § 4-1-105).

#### Comment to § 4-103 (A.C.A. § 4-4-103)

1. Section 1-102 (A.C.A. § 4-1-102) states the general principles and rules for variation of the effect of this Act by agreement and the limitations to this power. Section 4-103 (A.C.A. § 4-4-103) states the specific rules for variation of Article 4 (A.C.A. § 4-4-101 et seq.) by agreement and also certain standards of ordinary care. In view of the technical complexity of the field of bank collections, the enormous number of items handled by banks, the certainty that there will be variations from the normal in each day's work in each bank, the certainty of changing conditions and the possibility of developing improved methods of collection to speed the process, it would be unwise to freeze present methods of operation by mandatory statutory rules. This section, (A.C.A. § 3-4-103) therefore, permits within wide limits variation of the effect of provisions of the Article (Chapter) by agreement.

2. Subsection (a) (A.C.A. § 4-4-103(a)) confers blanket power to vary all provisions of the Article (Chapter) (A.C.A. § 4-4-101 et seq.) by agreements of the ordinary kind. The agreements may not disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care and may not limit the measure of damages for the lack or failure, but this subsection like Section 1-102(3)

(A.C.A. § 4-1-102(3)) approves the practice of parties determining by agreement the standards by which the responsibility is to be measured. In the absence of a showing that the standards manifestly are unreasonable, the agreement controls. Owners of items and other interested parties are not affected by agreements under this subsection unless they are parties to the agreement or are bound by adoption, ratification, estoppel or the like.

As here used "agreement" has the meaning given to it by Section 1-201(3) (A.C.A. § 4-1-201(3)). The agreement may be direct, as between the owner and the depository bank; or indirect, as in the case in which the owner authorizes a particular type of procedure and any bank in the collection chain acts pursuant to such authorization. It may be with respect to a single item; or to all items handled for a particular customer, e.g., a general agreement between the depository bank and the customer at the time a deposit account is opened. Legends on deposit tickets, collection letters and acknowledgments of items, coupled with action by the affected party constituting acceptance, adoption, ratification, estoppel or the like, are agreements if they meet the tests of the definition of "agreement." See Section 1-201(3) (A.C.A. § 4-1-201(3)). First Nat.



Bank of Denver v. Federal Reserve Bank, 6 F.2d 339 (8th Cir. 1925) (deposit slip); Jefferson County Bldg. Ass'n v. Southern Bank & Trust Co., 225 Ala. 25, 142 So. 66 (1932) (signature card and deposit slip); Semingson v. Stock Yards Nat. Bank, 162 Minn. 424, 203 N.W. 412 (1925) (pass-book); Farmers State Bank v. Union Nat. Bank, 42 N.D. 449, 454, 173 N.W. 789, 790 (1919) (acknowledgment of receipt of item).

3. Subsection (a) (A.C.A. § 4-4-103(a)) (subject to its limitations with respect to good faith and ordinary care) goes far to meet the requirements of flexibility. However, it does not by itself confer fully effective flexibility. Since it is recognized that banks handle a great number of items every business day and that the parties interested in each item include the owner of the item, the drawer (if it is a check), all nonbank indorsers, the payor bank and from one to five or more collecting banks, it is obvious that it is impossible, practically, to obtain direct agreements from all of these parties on all items. In total, the interested parties constitute virtually every adult person and business organization in the United States. On the other hand they may become bound to agreements on the principle that collecting banks acting as agents have authority to make binding agreements with respect to items being handled. This conclusion was assumed but was not flatly decided in *Federal Reserve Bank of Richmond v. Malloy*, 264 U.S. 160, at 167, 44 S.Ct. 296, at 298, 68 L.Ed. 617, 31 A.L.R. 1261 (1924).

To meet this problem subsection (b) (A.C.A. § 4-4-103(b)) provides that official or quasi-official rules of collection, that is Federal Reserve regulations and operating circulars, clearing-house rules, and the like, have the effect of agreements under subsection (a) (A.C.A. § 4-4-103(a)), whether or not specifically assented to by all parties interested in items handled. Consequently, such official or quasi-official rules may, standing by themselves but subject to the good faith and ordinary care limitations, vary the effect of the provisions of Article 4 (A.C.A. § 4-4-101 et seq.).

Federal Reserve regulations. Various sections of the Federal Reserve Act (12 U.S.C. § 221 et seq.) authorize the Board of Governors of the Federal Reserve Sys-

tem to direct the Federal Reserve banks to exercise bank collection functions. For example, Section 16 (12 U.S.C. § 248(o)) authorizes the Board to require each Federal Reserve bank to exercise the functions of a clearing-house for its members and Section 13 (12 U.S.C. § 342) authorizes each Federal Reserve bank to receive deposits from non-member banks solely for the purposes of exchange or of collection. Under this statutory authorization the Board has issued Regulation J (Subpart A—Collection of Checks and Other Items). Under the supremacy clause of the Constitution, federal regulations prevail over state statutes. Moreover, the Expedited Funds Availability Act, 12 U.S.C. Section 4007(b) provides that the Act and Regulation CC, 12 CFR 229, supersede "any provision of the law of any State, including the Uniform Commercial Code as in effect in such State, which is inconsistent with this chapter or such regulations." See Comment 1 to Section 4-102 (A.C.A. § 4-4-102).

Federal Reserve operating circulars. The regulations of the Federal Reserve Board authorize the Federal Reserve banks to promulgate operating circulars covering operating details. Regulation J, for example, provides that "Each Reserve Bank shall receive and handle items in accordance with this subpart, and shall issue operating circulars governing the details of its handling of items and other matters deemed appropriate by the Reserve Bank." This Article (Chapter) (A.C.A. § 4-4-101 et seq.) recognizes that "operating circulars" issued pursuant to the regulations and concerned with operating details as appropriate may, within their proper sphere, vary the effect of the Article (Chapter) (A.C.A. § 4-4-101 et seq.).

Clearing-House Rules. Local clearing houses have long issued rules governing the details of clearing; hours of clearing, media of remittance, time for return of mis-sent items and the like. The case law has recognized these rules, within their proper sphere, as binding on affected parties and as appropriate sources for the courts to look to in filling out details of bank collection law. Subsection (b) (A.C.A. § 4-4-103(b)) in recognizing clearing-house rules as a means of preserving flexibility continues the sensible approach indicated in the cases. Included in the

term "clearing houses" are county and regional clearing houses as well as those within a single city or town. There is, of course, no intention of authorizing a local clearing house or a group of clearing houses to rewrite the basic law generally. The term "clearing-house rules" should be understood in the light of functions the clearing houses have exercised in the past.

And the like. This phrase is to be construed in the light of the foregoing. "Federal Reserve regulations and operating circulars" cover rules and regulations issued by public or quasi-public agencies under statutory authority. "Clearing-house rules" cover rules issued by a group of banks which have associated themselves to perform through a clearing house some of their collection, payment and clearing functions. Other agencies or associations of this kind may be established in the future whose rules and regulations could be appropriately looked on as constituting means of avoiding absolute statutory rigidity. The phrase "and the like" leaves open possibilities for future development. An agreement between a number of banks or even all the banks in an area simply because they are banks, would not of itself, by virtue of the phrase "and the like," meet the purposes and objectives of subsection (b) (A.C.A. § 4-4-103(b)).

4. Under this Article (Chapter) (A.C.A. § 4-4-101 et seq.) banks come under the general obligations of the use of good faith and the exercise of ordinary care. "Good faith" is defined in Section 3-103(a)(4) (A.C.A. § 4-3-103(a)(4)). The term "ordinary care" is defined in Section 3-103(a)(7) (A.C.A. § 4-3-103(a)(7)). These definitions are made to apply to Article 4 (A.C.A. § 4-4-101 et seq.) by Section 4-104(c) (A.C.A. § 4-4-104(c)). Section 4-202 (A.C.A. § 4-4-202) states respects in which collecting banks must use ordinary care. Subsection (c) of Section 4-103 (A.C.A. § 4-4-103(c)) provides that action or non-action approved by the Article (Chapter) (A.C.A. § 4-4-101 et seq.) or pursuant to Federal Reserve regulations or operating circulars constitutes the exercise of ordinary care. Federal Reserve regulations and operating circulars constitute an affirmative standard of ordinary care equally with the provisions of Article 4 (A.C.A. § 4-4-101 et seq.) itself.

Subsection (c) (A.C.A. § 4-4-103(c)) fur-

ther provides that, absent special instructions, action or non-action consistent with clearing-house rules and the like or with a general banking usage not disapproved by the Article (Chapter) (A.C.A. § 4-4-101 et seq.), prima facie constitutes the exercise of ordinary care. Clearing-house rules and the phrase "and the like" have the significance set forth above in these Comments. The term "general banking usage" is not defined but should be taken to mean a general usage common to banks in the area concerned. See Section 1-205(2) (A.C.A. § 4-1-205(2)). In a case in which the adjective "general" is used, the intention is to require a usage broader than a mere practice between two or three banks but it is not intended to require anything as broad as a country-wide usage. A usage followed generally throughout a state, a substantial portion of a state, a metropolitan area or the like would certainly be sufficient. Consistently with the principle of Section 1-205(3) (A.C.A. § 4-1-205(3)), action or non-action consistent with clearing-house rules or the like or with banking usages prima facie constitutes the exercise of ordinary care. However, the phrase "in the absence of special instructions" affords owners of items an opportunity to prescribe other standards and although there may be no direct supervision or control of clearing houses or banking usages by official supervisory authorities, the confirmation of ordinary care by compliance with these standards is prima facie only, thus conferring on the courts the ultimate power to determine ordinary care in any case in which it should appear desirable to do so. The prima facie rule does, however, impose on the party contesting the standards to establish that they are unreasonable, arbitrary or unfair as used by the particular bank.

5. Subsection (d) (A.C.A. § 4-4-103(d)), in line with the flexible approach required for the bank collection process is designed to make clear that a novel procedure adopted by a bank is not to be considered unreasonable merely because that procedure is not specifically contemplated by this Article (Chapter) (A.C.A. § 4-4-101 et seq.) or by agreement, or because it has not yet been generally accepted as a bank usage. Changing conditions constantly call for new procedures and someone has to use the new procedure first. If this procedure is found to be reasonable under



the circumstances, provided, of course, that it is not inconsistent with any provision of the Article (Chapter) (A.C.A. § 4-4-101 et seq.) or other law or agreement, the bank which has followed the new procedure should not be found to have failed in the exercise of ordinary care.

6. Subsection (e) (A.C.A. § 4-4-103(e)) sets forth a rule for determining the measure of damages for failure to exercise ordinary care which, under subsection (a) (A.C.A. § 4-4-103(a)), cannot be limited by agreement. In the absence of bad faith the maximum recovery is the amount of the item concerned. The term "bad faith" is not defined; the connotation is the absence of good faith (Section 3-103) (A.C.A. § 4-3-103). When it is established that some

part or all of the item could not have been collected even by the use of ordinary care the recovery is reduced by the amount that would have been in any event uncollectible. This limitation on recovery follows the case law. Finally, if bad faith is established the rule opens to allow the recovery of other damages, whose "proximateness" is to be tested by the ordinary rules applied in comparable cases. Of course, it continues to be as necessary under subsection (e) (A.C.A. § 4-4-103(e)) as it has been under ordinary common law principles that, before the damage rule of the subsection becomes operative, liability of the bank and some loss to the customer or owner must be established.

### Comment to § 4-104 (A.C.A. § 4-4-104)

1. Paragraph (a)(1) (A.C.A. § 4-4-104-(a)(1)): "Account" is defined to include both asset accounts in which a customer has deposited money and accounts from which a customer may draw on a line of credit. The limiting factor is that the account must be in a bank.

2. Paragraph (a)(3) (A.C.A. § 4-4-104-(a)(3)): "Banking day." Under this definition that part of a business day when a bank is open only for limited functions, e.g., to receive deposits and cash checks, but with loan, bookkeeping and other departments closed, is not part of a banking day.

3. Paragraph (a)(4) (A.C.A. § 4-4-104-(a)(4)): "Clearing House." Occasionally express companies, governmental agencies and other nonbanks deal directly with a clearing house; hence the definition does not limit the term to an association of banks.

4. Paragraph (a)(5) (A.C.A. § 4-4-104-(a)(5)): "Customer." It is to be noted that this term includes a bank carrying an account with another bank as well as the more typical nonbank customer or depositor.

5. Paragraph (a)(6) (A.C.A. § 4-4-104-(a)(6)): "Documentary draft" applies even though the documents do not accompany the draft but are to be received by the drawee or other payor before acceptance or payment of the draft.

6. Paragraph (a)(7) (A.C.A. § 4-4-104-(a)(7)): "Draft" is defined in Section 3-104

(A.C.A. § 4-3-104) as a form of instrument. Since Article 4 (A.C.A. § 4-4-101 et seq.) applies to items that may not fall within the definition of instrument, the term is defined here to include an item that is a written order to pay money, even though the item may not qualify as an instrument. The term "order" is defined in Section 3-103 (A.C.A. § 4-3-103).

7. Paragraph (a)(8) (A.C.A. § 4-4-104-(a)(8)): "Drawee" is defined in Section 3-103 (A.C.A. § 4-3-103) in terms of an Article 3 (A.C.A. § 4-3-101 et seq.) draft which is a form of instrument. Here "drawee" is defined in terms of an Article 4 (A.C.A. § 4-4-101 et seq.) draft which includes items that may not be instruments.

8. Paragraph (a)(9) (A.C.A. § 4-4-104-(a)(9)): "Item" is defined broadly to include an instrument, as defined in Section 3-104 (A.C.A. § 4-3-104), as well as promises or orders that may not be within the definition of "instrument." The terms "promise" and "order" are defined in Section 3-103 (A.C.A. § 4-3-103). A promise is a written undertaking to pay money. An order is a written instruction to pay money. But see Section 4-110(c) (A.C.A. § 4-4-110(c)). Since bonds and other investment securities under Article 8 (A.C.A. § 4-8-101 et seq.) may be within the term "instrument" or "promise," they are items and when handled by banks for collection are subject to this Article (Chapter) (A.C.A. § 4-4-101 et seq.). See Comment 1 to Section 4-102 (A.C.A. § 4-4-102). The functional limita-

tion on the meaning of this term is the willingness of the banking system to handle the instrument, undertaking or instruction for collection or payment.

9. Paragraph (a)(10) (A.C.A. § 4-4-104(a)(10)): "Midnight deadline." The use of this phrase is an example of the more mechanical approach used in this Article (Chapter) (A.C.A. § 4-4-101 et seq.). Midnight is selected as a termination point or time limit to obtain greater uniformity and definiteness than would be possible from other possible terminating points, such as the close of the banking day or business day.

10. Paragraph (a)(11) (A.C.A. § 4-4-104(a)(11)): The term "settle" has substantial importance throughout Article 4 (A.C.A. § 4-4-101 et seq.). In the American Bankers Association Bank Collection Code, in deferred posting statutes, in Federal Reserve regulations and operating circulars, in clearing-house rules, in agreements between banks and customers and in legends on deposit tickets and collection letters, there is repeated reference to "conditional" or "provisional" credits or payments. Tied in with this concept of credits or payments being in some way tentative, has been a related but somewhat different problem as to when an item is "paid" or "finally paid" either to determine the relative priority of the item as against attachments, stop-payment orders and the like or in insolvency situations. There has been extensive litigation in the various states on these problems. To a substantial extent the confusion, the litigation and even the resulting court decisions fail to take into account that in the collection process some debits or credits are provisional or tentative and others are final and that very many debits or credits are provisional or tentative for

awhile but later become final. Similarly, some cases fail to recognize that within a single bank, particularly a payor bank, each item goes through a series of processes and that in a payor bank most of these processes are preliminary to the basic act of payment or "final payment."

The term "settle" is used as a convenient term to characterize a broad variety of conditional, provisional, tentative and also final payments of items. Such a comprehensive term is needed because it is frequently difficult or unnecessary to determine whether a particular action is tentative or final or when a particular credit shifts from the tentative class to the final class. Therefore, its use throughout the Article (Chapter) (A.C.A. § 4-4-101 et seq.) indicates that in that particular context it is unnecessary or unwise to determine whether the debit or the credit or the payment is tentative or final. However, if qualified by the adjective "provisional" its tentative nature is intended, and if qualified by the adjective "final" its permanent nature is intended.

Examples of the various types of settlement contemplated by the term include payments in cash; the efficient but somewhat complicated process of payment through the adjustment and offsetting of balances through clearing houses; debit or credit entries in accounts between banks; the forwarding of various types of remittance instruments, sometimes to cover a particular item but more frequently to cover an entire group of items received on a particular day.

11. Paragraph (a)(12) (A.C.A. § 4-4-104(a)(12)): "Suspends payments." This term is designed to afford an objective test to determine when a bank is no longer operating as a part of the banking system.

### Comment to § 4-105 (A.C.A. § 4-4-105)

1. The definitions in general exclude a bank to which an item is issued, as this bank does not take by transfer except in the particular case covered in which the item is issued to a payee for collection, as in the case in which a corporation is transferring balances from one account to another. Thus, the definition of "depository bank" does not include the bank to which a check is made payable if a check

is given in payment of a mortgage. This bank has the status of a payee under Article 3 (A.C.A. § 4-3-101 et seq.) on Negotiable Instruments and not that of a collecting bank.

2. Paragraph (1) (A.C.A. § 4-4-105(1)): "Bank" is defined in Section 1-201(4) (A.C.A. § 4-1-201(4)) as meaning "any person engaged in the business of banking." The definition in paragraph (1)



(A.C.A. § 4-4-105(1)) makes clear that "bank" includes savings banks, savings and loan associations, credit unions and trust companies, in addition to the commercial banks commonly denoted by use of the term "bank."

3. Paragraph (2) (A.C.A. § 4-4-105(2)): A bank that takes an "on use" item for collection, for application to a customer's loan, or first handles the item for other reasons is a depository bank even though it is also the payor bank. However, if the holder presents the item for immediate payment over the counter, the payor bank is not a depository bank.

4. Paragraph (3) (A.C.A. § 4-4-105(3)): The definition of "payor bank" is clarified by use of the term "drawee." That term is defined in Section 4-104 (A.C.A. § 4-4-104) as meaning "a person ordered in a

draft to make payment." An "order" is defined in Section 3-103 (A.C.A. § 4-3-103) as meaning "a written instruction to pay money.... An authorization to pay is not an order unless the person authorized to pay is also instructed to pay." The definition of order is incorporated into Article 4 (A.C.A. § 4-4-101 et seq.) by Section 4-104(c) (A.C.A. § 4-4-104(c)). Thus a payor bank is one instructed to pay in the item. A bank does not become a payor bank by being merely authorized to pay or by being given an instruction to pay not contained in the item.

5. Paragraph (4) (A.C.A. § 4-4-105(4)): The term "intermediary bank" includes the last bank in the collection process if the drawee is not a bank. Usually the last bank is also a presenting bank.

#### **Comment to § 4-106 (A.C.A. § 4-4-106)\***

1. This section (A.C.A. § 4-4-106) replaces former Sections 3-120 and 3-121. Some items are made "payable through" a particular bank. Subsection (a) (A.C.A. § 4-4-106(a)) states that such language makes the bank a collecting bank and not a payor bank. An item identifying a "payable through" bank can be presented for payment to the drawee only by the "payable through" bank. The item cannot be presented to the drawee over the counter for immediate payment or by a collecting bank other than the "payable through" bank.

2. Subsection (b) (A.C.A. § 4-4-106(b)) retains the alternative approach of the present law. Under Alternative A a note payable at a bank is the equivalent of a draft drawn on the bank and the midnight deadline provisions of Sections 4-301 and

4-302 (A.C.A. §§ 4-4-301 and 4-4-302) apply. Under Alternative B\* a "payable at" bank is in the same position as a "payable through" bank under subsection (a) (A.C.A. § 4-4-106(a)).

3. Subsection (c) (A.C.A. § 4-4-106(c)) rejects the view of some cases that a bank named below the name of a drawee is itself a drawee. The commercial understanding is that this bank is a collecting bank and is not accountable under Section 4-302 (A.C.A. § 4-4-302) for holding an item beyond its deadline. The liability of the bank is governed by Sections 4-202(a) and 4-103(e) (A.C.A. §§ 4-4-202(a) and 4-4-103(e)).

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\*Arkansas has enacted Alternative B.

#### **Comment to § 4-107 (A.C.A. § 4-4-107)**

1. A rule with respect to the status of a branch or separate office of a bank as a part of any statute on bank collections is highly desirable if not absolutely necessary. However, practices in the operations of branches and separate offices vary substantially in the different states and it has not been possible to find any single rule that is logically correct, fair in all situations and workable under all different types of practices. The decision not to

draft the section (A.C.A. § 4-4-107) with greater specificity leaves to the courts the resolution of the issues arising under this section on the basis of the facts of each case.

2. In many states and for many purposes a branch or separate office of the bank should be treated as a separate bank. Many branches function as separate banks in the handling and payment of items and require time for doing so simi-

lar to that of a separate bank. This is particularly true if branch banking is permitted throughout a state or in different towns and cities. Similarly, if there is this separate functioning a particular branch or separate office is the only proper place for various types of action to be taken or orders or notices to be given. Examples include the drawing of a check on a particular branch by a customer whose account is carried at that branch; the presentment of that same check at that branch; the issuance of an order to the branch to stop payment on the check.

3. Section 1 of the American Bankers Association Bank Collection Code provided simply: "A branch or office of any such bank shall be deemed a bank." Although this rule appears to be brief and simple, as applied to particular sections of the ABA Code it produces illogical and, in some cases, unreasonable results. For example, under Section 11 of the ABA Code it seems anomalous for one branch of a bank to have charged an item to the account of the drawer and another branch to have the power to elect to treat the item as dishonored. Similar logical problems would flow from applying the same rule to Article 4 (A.C.A. § 4-4-101 et seq.). Warranties by one branch to another branch under Sections 4-207 and 4-208 (A.C.A. §§ 4-4-207 and 4-4-208) (each considered a separate bank) do not make sense.

4. Assuming that it is not desirable to make each branch a separate bank for all purposes, this section provides that a branch or separate office is a separate bank for certain purposes. In so doing the single legal entity of the bank as a whole is preserved, thereby carrying with it the liability of the institution as a whole on such obligations as it may be under. On the other hand, in cases in which the

Article (Chapter) (A.C.A. § 4-4-101 et seq.) provides a number of time limits for different types of action by banks, if a branch functions as a separate bank, it should have the time limits available to a separate bank. Similarly if in its relations to customers a branch functions as a separate bank, notices and orders with respect to accounts of customers of the branch should be given at the branch. For example, whether a branch has notice sufficient to affect its status as a holder in due course of an item taken by it should depend upon what notice that branch has received with respect to the item. Similarly the receipt of a stop-payment order at one branch should not be notice to another branch so as to impair the right of the second branch to be a holder in due course of the item, although in circumstances in which ordinary care requires the communication of a notice or order to the proper branch of a bank, the notice or order would be effective at the proper branch from the time it was or should have been received. See Section 1-201(27) (A.C.A. § 4-1-201(27)).

5. The bracketed language ("maintaining its own deposit ledger") in former Section 4-106 is deleted. Today banks keep records on customer accounts by electronic data storage. This has led most banks with branches to centralize to some degree their record keeping. The place where records are kept has little meaning if the information is electronically stored and is instantly retrievable at all branches of the bank. Hence, the inference to be drawn from the deletion of the bracketed language is that where record keeping is done is no longer an important factor in determining whether a branch is a separate bank.

#### Comment to § 4-108 (A.C.A. § 4-4-108)

1. Each of the huge volume of checks processed each day must go through a series of accounting procedures that consume time. Many banks have found it necessary to establish a cutoff hour to allow time for these procedures to be completed within the time limits imposed by Article 4 (A.C.A. § 4-4-101 et seq.). Subsection (a) (A.C.A. § 4-4-108(a)) approves a cutoff hour of this type provided it is not

earlier than 2 P.M. Subsection (b) (A.C.A. § 4-4-108(b)) provides that if such a cutoff hour is fixed, items received after the cutoff hour may be treated as being received at the opening of the next banking day. If the number of items received either through the mail or over the counter tends to taper off radically as the afternoon hours progress, a 2 P.M. cutoff hour does not involve a large portion of the items



received but at the same time permits a bank using such a cutoff hour to leave its doors open later in the afternoon without forcing into the evening the completion of its settling and proving process.

2. The provision in subsection (b) (A.C.A. § 4-4-108(b)) that items or deposits received after the close of the banking day may be treated as received at the

opening of the next banking day is important in cases in which a bank closes at twelve or one o'clock, e.g., on a Saturday, but continues to receive some items by mail or over the counter if, for example, it opens Saturday evening for the limited purpose of receiving deposits and cashing checks.

### Comment to § 4-109 (A.C.A. § 4-4-109)

1. Sections 4-202(b), 4-214, 4-301, and 4-302 (A.C.A. §§ 4-4-202(b), 4-4-214, 4-4-301, and 4-4-302) prescribe various time limits for the handling of items. These are the limits of time within which a bank, in fulfillment of its obligation to exercise ordinary care, must handle items entrusted to it for collection or payment. Under Section 4-103 (A.C.A. 4-4-103) they may be varied by agreement or by Federal Reserve regulations or operating circular, clearing-house rules, or the like. Subsection (a) (A.C.A. § 4-4-109(a)) permits a very limited extension of these time limits. It authorizes a collecting bank to take additional time in attempting to collect drafts drawn on nonbank payors with or without the approval of any interested party. The right of a collecting bank to waive time limits under subsection (a) (A.C.A. § 4-4-109(a)) does not apply to checks. The two-day extension can only by granted in a good faith effort to secure payment and only with respect to specific items. It cannot be exercised if the customer instructs otherwise. Thus limited, the escape provision should afford a limited degree of flexibility in special cases but should not interfere with the overall requirement and objective of speedy collections.

2. An extension granted under subsection (a) (A.C.A. § 4-4-109(a)) is without discharge of drawers or indorsers. It therefore extends the times for present-

ment or payment as specified in Article 3 (A.C.A. § 4-3-101 et seq.).

3. Subsection (b) (A.C.A. § 4-4-109(b)) is another escape clause from time limits. This clause operates not only with respect to time limits imposed by the Article (Chapter) (A.C.A. § 4-4-101 et seq.) itself but also time limits imposed by special instructions, by agreement or by Federal regulations or operating circulars, clearing-house rules or the like. The latter time limits are "permitted" by the Code. For example, a payor bank that fails to make timely return of a dishonored item may be accountable for the amount of the item. Subsection (b) (A.C.A. § 4-4-109(b)) excuses a bank from this liability when its failure to meet its midnight deadline resulted from, for example, a computer breakdown that was beyond the control of the bank, so long as the bank exercised the degree of diligence that the circumstances required. In *Port City State Bank v. American National Bank*, 486 F.2d 196 (10th Cir. 1973), the court held that a bank exercised sufficient diligence to be excused under this subsection. If delay is sought to be excused under this subsection, the bank has the burden on proof on the issue of whether it exercised "such diligence as the circumstances require." The subsection (A.C.A. § 4-4-109(b)) is consistent with Regulation CC, Section 229.38(e).

### Comment to § 4-110 (A.C.A. § 4-4-110)

1. "An agreement for electronic presentment" refers to an agreement under which presentment may be made to a payor bank by a presentment notice rather than by presentment of the item. Under imaging technology now under development, the presentment notice might

be an image of the item. The electronic presentment agreement may provide that the item may be retained by a depository bank, other collecting bank, or it may provide that the item will follow the presentment notice. The identifying characteristic of an electronic presentment

agreement is that presentment occurs when the presentment notice is received. "An agreement for electronic presentment" does not refer to the common case of retention of items by payor banks because the item itself is presented to the payor bank in these cases. Payor bank check retention is a matter of agreement between payor banks and their customers. Provisions on payor bank check retention are found in Section 4-406(b) (A.C.A. § 4-406(b)).

2. The assumptions under which the electronic presentment amendments are based are as follows: No bank will participate in an electronic presentment program without an agreement. These agreements may be either bilateral (Section 4-103(a)) (A.C.A. § 4-4-103(a)), under which two banks that frequently do business with each other may agree to depositary bank check retention, or multilateral (Section 4-103(b)) (A.C.A. § 4-4-103(b)), in which large segments of the banking industry may participate in such a program. In the latter case, federal or other uniform regulatory standards would likely supply the substance of the electronic presentment agreement, the application of which could be triggered by the use of some form of identifier on the item. Regulation CC,

Section 229.36(c) authorizes truncation agreements but forbids them from extending return times or otherwise varying requirements of the part of Regulation CC governing check collection without the agreement of all parties interested in the check. For instance, an extension of return time could damage a depositary bank which must make funds available to its customers under mandatory availability schedules. The Expedited Funds Availability Act, 12 U.S.C. Section 4008(b)(2), directs the Federal Reserve Board to consider requiring that banks provide for check truncation.

3. The parties affected by an agreement for electronic presentment, with the exception of the customer, can be expected to protect themselves. For example, the payor bank can probably be expected to limit its risk of loss from drawer forgery by limiting the dollar amount of eligible items (Federal Reserve program), by reconciliation agreements (ABA Safekeeping program), by insurance (credit union share draft program), or by other means. Because agreements will exist, only minimal amendments are needed to make clear that the UCC does not prohibit electronic presentment.

#### **Comment to § 4-111 (A.C.A. § 4-4-111)**

This section (A.C.A. § 4-4-111) conforms to the period of limitations set by Section 3-118(g) (A.C.A. § 4-3-118(g)) for actions for breach of warranty and to enforce other obligations, duties or rights

arising under Article 3 (A.C.A. § 4-3-101 et seq.). Bracketing "cause of action" recognizes that some states use a different term, such as "claim for relief."

#### **Comment to § 4-201 (A.C.A. § 4-4-201)**

1. This section (A.C.A. § 4-4-201) states certain basic rules of the bank collection process. One basic rule, appearing in the last sentence of subsection (a) (A.C.A. § 4-4-201(a)), is that, to the extent applicable, the provisions of the Article (Chapter) (A.C.A. § 4-4-101 et seq.) govern without regard to whether a bank handling an item owns the item or is an agent for collection. Historically, much time has been spent and effort expended in determining or attempting to determine whether a bank was a purchaser of an item or merely an agent for collection. See discussion of this subject and cases

cited in 11 A.L.R. 1043, 16 A.L.R. 1084, 42 A.L.R. 492, 68 A.L.R. 725, 99 A.L.R. 486. See also Section 4 of the American Bankers Association Bank Collection Code. The general approach of Article 4 (A.C.A. § 4-4-101 et seq.), similar to that of other articles, is to provide, within reasonable limits, rules or answers to major problems known to exist in the bank collection process without regard to questions of status and ownership but to keep general principles such as status and ownership available to cover residual areas not covered by specific rules. In line with this approach, the last sentence of subsection (a) (A.C.A.



§ 4-4-201(a)) says in effect that Article 4 (A.C.A. § 4-4-101 et seq.) applies to practically every item moving through banks for the purpose of presentment, payment or collection.

2. Within this general rule of broad coverage, the first two sentences of subsection (a) (A.C.A. § 4-4-201(a)) state a rule of agency status. "Unless a contrary intent clearly appears" the status of a collecting bank is that of an agent or sub-agent for the owner of the item. Although as indicated in Comment 1 it is much less important under Article 4 (A.C.A. § 4-4-101 et seq.) to determine status than has been the case heretofore, status may have importance in some residual areas not covered by specific rules. Further, since status has been considered so important in the past, to omit all reference to it might cause confusion. The status of agency "applies regardless of the form of indorsement or lack of indorsement and even though credit given for the item is subject to immediate withdrawal as of right or is in fact withdrawn." Thus questions heretofore litigated as to whether ordinary indorsements "for deposit," "for collection" or in blank have the effect of creating an agency status or a purchase, no longer have significance in varying the prima facie rule of agency. Similarly, the nature of the credit given for an item or whether it is subject to immediate withdrawal as of right or is in fact withdrawn, does not alter the agency status. See A.L.R. references *supra* in Comment 1.

A contrary intent can change agency status but this must be clear. An example of a clear contrary intent would be if collateral papers established or the item bore a legend stating that the item was sold absolutely to the depository bank.

3. The prima facie agency status of collecting banks is consistent with prevailing law and practice today. Section 2 of the American Bankers Association Bank Collection Code so provided. Legends on deposit tickets, collection letters and acknowledgments of items and Federal Reserve operating circulars consistently so provide. The status is consistent with rights of charge-back (Section 4-214 (A.C.A. § 4-4-214) and Section 11 of the ABA Code) and risk of loss in the event of insolvency (Section 4-216 (A.C.A. § 4-4-216) and Section 13 of the ABA Code). The

right of charge-back with respect to checks is limited by Regulation CC, Section 226.36(d).

4. Affirmative statement of a prima facie agency status for collecting banks requires certain limitations and qualifications. Under current practices substantially all bank collections sooner or later merge into bank credits, at least if collection is effected. Usually, this takes place within a few days of the initiation of collection. An intermediary bank receives final collection and evidences the result of its collection by a "credit" on its books to the depository bank. The depository bank evidences the results of its collection by a "credit" in the account of its customer. As used in these instances the term "credit" clearly indicates a debtor-creditor relationship. At some stage in the bank collection process the agency status of a collecting bank changes to that of debtor, a debtor of its customer. Usually at about the same time it also becomes a creditor for the amount of the item, a creditor of some intermediary, payor or other bank. Thus the collection is completed, all agency aspects are terminated and the identity of the item has become completely merged in bank accounts, that of the customer with the depository bank and that of one bank with another.

Although Section 4-215(a) (A.C.A. § 4-4-215(a)) provides that an item is finally paid when the payor bank takes or fails to take certain action with respect to the item, the final payment of the item may or may not result in the simultaneous final settlement for the item in the case of all prior parties. If a series of provisional debits and credits for the item have been entered in accounts between banks, the final payment of the item by the payor bank may result in the automatic firming up of all those provisional debits and credits under Section 4-215(c) (A.C.A. § 4-4-215(c)), and the consequent receipt of final settlement for the item by each collecting bank and the customer of the depository bank simultaneously with such action of the payor bank. However, if the payor bank or some intermediary bank accounts for the item with a remittance draft, the next prior bank usually does not receive final settlement for the item until the remittance draft finally clears. See Section 4-213(c) (A.C.A. § 4-4-213(c)). The first sentence of subsection (a) (A.C.A.

§ 4-4-201(a)) provides that the agency status of a collecting bank (whether intermediary or depository) continues until the settlement given by it for the item is or becomes final. In the case of the series of provisional credits covered by Section 4-215(c) (A.C.A. § 4-4-215(c)), this could be simultaneously with the final payment of the item by the payor bank. In cases in which remittance drafts are used or in straight noncash collections, this would not be until the times specified in Sections 4-213(c) and 4-215(d) (A.C.A. §§ 4-4-213(c) and 4-4-215(d)). With respect to checks Regulation CC Sections 229.31(c), 229.32(b) and 229.36(d) provide that all settlements between banks are final in both the forward collection and return of checks.

Under Section 4-213(a) (A.C.A. § 4-4-213(a)) settlements for items may be made by any means agreed to by the parties. Since it is impossible to contemplate all the kinds of settlements that will be utilized, no attempt is made in Article 4 (A.C.A. § 4-4-101 et seq.) to provide when settlement is final in all cases. The guiding principle is that settlements should be final when the presenting person has received usable funds. Section 4-213(c) and (d) and Section 4-215(c) (A.C.A. § 4-4-213(c) and (d) and § 4-4-215(c)) provide when final settlement occurs with respect to certain kinds of settlement, but these provisions are not intended to be exclusive.

A number of practical results flow from the rule continuing the agency status of a collecting bank until its settlement for the item is or becomes final, some of which are specifically set forth in this Article (Chapter) (A.C.A. § 4-4-101 et seq.) One is that risk of loss continues in the owner of the item rather than the agent bank. See Section 4-214 (A.C.A. § 4-4-214). Offsetting rights favorable to the owner are that pending such final settlement, the owner has the preference rights of Section 4-216 (A.C.A. § 4-4-216) and the direct rights of Section 4-302 (A.C.A. § 4-4-302) against the payor bank. It also follows from this rule that the dollar limitations of Federal Deposit Insurance are measured by the claim of the owner of the item rather than that of the collecting bank. With respect to checks, rights of the parties in insolvency are determined by Regulation CC Section 229.39 and the liability of a bank handling

a check to a subsequent bank that does not receive payment because of suspension of payments by another bank is stated in Regulation CC Section 229.35(b).

5. In those cases in which some period of time elapses between the final payment of the item by the payor bank and the time that the settlement of the collecting bank is or becomes final, e.g., if the payor bank or an intermediary bank accounts for the item with a remittance draft or in straight noncash collections, the continuance of the agency status of the collecting bank necessarily carries with it the continuance of the owner's status as principal. The second sentence of subsection (a) (A.C.A. § 4-4-201(a)) provides that whatever rights the owner has to proceeds of the item are subject to the rights of collecting banks for outstanding advances on the item and other valid rights, if any. The rule provides a sound rule to govern cases of attempted attachment of proceeds of a noncash item in the hands of the payor bank as property of the absent owner. If a collecting bank has made an advance on an item which is still outstanding, its right to obtain reimbursement for this advance should be superior to the rights of the owner to the proceeds or to the rights of a creditor of the owner. An intentional crediting of proceeds of an item to the account of a prior bank known to be insolvent, for the purpose of acquiring a right of setoff, would not produce a valid setoff. See 8 Zollman, Banks and Banking (1936) Sec. 5443.

6. This section (A.C.A. § 4-4-201) and Article 4 (A.C.A. § 4-4-101 et seq.) as a whole represent an intentional abandonment of the approach to bank collection problems appearing in Section 4 of the American Bankers Association Bank Collection Code. Because the tremendous volume of items handled makes impossible the examination by all banks of all indorsements on all items and thus in fact this examination is not made, except perhaps by depository banks, it is unrealistic to base the rights and duties of all banks in the collection chain on variations in the form of indorsements. It is anomalous to provide throughout the ABA Code that the prima facie status of collecting banks is that of agent or sub-agent but in Section 4 to provide that subsequent holders (sub-agents) shall have the right to rely on the



presumption that the bank of deposit (the primary agent) is the owner of the item. It is unrealistic, particularly in this background, to base rights and duties on status of agent or owner. Thus Section 4-201 (A.C.A. § 4-4-201) makes the pertinent provisions of Article 4 (A.C.A. § 4-4-101 et seq.) applicable to substantially all items handled by banks for presentment, payment or collection, recognizes the prima facie status of most banks as agents, and then seeks to state appropriate limits and some attributes to the general rules so expressed.

7. Subsection (b) (A.C.A. § 4-4-201(b)) protects the ownership rights with respect to an item indorsed "pay any bank or banker" or in similar terms of a customer initiating collection or of any bank acquiring a security interest under Section 4-210 (A.C.A. § 4-4-210), in the event the item is subsequently acquired under improper circumstances by a person who is not a bank and transferred by that person to

another person, whether or not a bank. Upon return to the customer initiating collection of an item so indorsed, the indorsement may be canceled (Section 3-207) (A.C.A. § 4-3-207). A bank holding an item so indorsed may transfer the item out of banking channels by special indorsement; however, under Section 4-103(e) (A.C.A. § 4-4-103(e)), the bank would be liable to the owner of the item for any loss resulting therefrom if the transfer had been made in bad faith or with lack of ordinary care. If briefer and more simple forms of bank indorsements are developed under Section 4-206 (A.C.A. § 4-4-206) (e.g., the use of bank transit numbers in lieu of present lengthy forms of bank indorsements), a depository bank having the transit number "X100" could make subsection (b) (A.C.A. § 4-4-201(b)) operative by indorsements such as "Pay any bank—X100." Regulation CC Section 229.35(c) states the effect of an indorsement on a check by a bank.

#### Comment to § 4-202 (A.C.A. § 4-4-202)

1. Subsection (a) (A.C.A. § 4-4-202(a)) states the basic responsibilities of a collecting bank. Of course, under Section 1-203 (A.C.A. § 4-1-203) a collecting bank is subject to the standard requirement of good faith. By subsection (a) (A.C.A. § 4-4-202(a)) it must also use ordinary care in the exercise of its basic collection tasks. By Section 4-103(a) (A.C.A. § 4-4-103(a)) neither requirement may be disclaimed.

2. If the bank makes presentment itself, subsection (a)(1) (A.C.A. § 4-4-202(a)(1)) requires ordinary care with respect both to the time and manner of presentment. (Sections 3-501 and 4-212.) (A.C.A. §§ 4-3-501 and 4-4-212) If it forwards the item to be presented the subsection requires ordinary care with respect to routing (Section 4-204) (A.C.A. § 4-4-204), and also in the selection of intermediary banks or other agents.

3. Subsection (a) (A.C.A. § 4-4-202(a)) describes types of basic action with respect to which a collecting bank must use ordinary care. Subsection (b) (A.C.A. § 4-4-202(b)) deals with the time for taking action. It first prescribes the general standard for timely action, namely, for items received on Monday, proper action (such as forwarding or presenting) on Monday

or Tuesday is timely. Although under current "production line" operations banks customarily move items along on regular schedules substantially briefer than two days, the subsection states an outside time within which a bank may know it has taken timely action. To provide flexibility from this standard norm, the subsection further states that action within a reasonably longer time may be timely but the bank has the burden of proof. In the case of time items, action after the midnight deadline, but sufficiently in advance of maturity for proper presentation, is a clear example of a "reasonably longer time" that is timely. The standard of requiring action not later than Tuesday in the case of Monday items is also subject to possibilities of variation under the general provisions of Section 4-103 (A.C.A. § 4-4-103), or under the special provisions regarding time of receipt of items (Section 4-108) (A.C.A. § 4-4-108), and regarding delays (Section 4-109) (A.C.A. § 4-4-109). This subsection (b) (A.C.A. § 4-4-202(b)) deals only with collecting banks. The time limits applicable to payor banks appear in Sections 4-301 and 4-302 (A.C.A. §§ 4-4-301 and 4-4-302).

4. At common law the so-called New

York collection rule subjected the initial collecting bank to liability for the actions of subsequent banks in the collection chain; the so-called Massachusetts rule was that each bank, subject to the duty of selecting proper intermediaries, was liable only for its own negligence. Subsection (c) (A.C.A. § 4-4-202(c)) adopts the Massachusetts rule. But since this is stated to

be subject to subsection (a)(1) (A.C.A. § 4-4-202(a)(1)) a collecting bank remains responsible for using ordinary care in selecting properly qualified intermediary banks and agents and in giving proper instructions to them. Regulation CC Section 229.36(d) states the liability of a bank during the forward collection of checks.

### **Comment to § 4-203 (A.C.A. § 4-4-203)**

This section (A.C.A. § 4-4-203) adopts a "chain of command" theory which renders it unnecessary for an intermediary or collecting bank to determine whether its transferor is "authorized" to give the instructions. Equally the bank is not put on notice of any "revocation of authority" or "lack of authority" by notice received from any other person. The desirability of speed in the collection process and the fact that, by reason of advances made, the transferor may have the paramount interest in the item requires the rule.

The section is made subject to the provisions of Article 3 (A.C.A. § 4-3-101 et seq.) concerning conversion of instruments (Section 3-420) (A.C.A. § 4-3-420) and restrictive indorsements (Section 3-206) (A.C.A. § 4-3-206). Of course instructions from or an agreement with it transferor does not relieve a collecting bank of its general obligation to exercise

good faith and ordinary care. See Section 4-103(a) (A.C.A. § 4-4-103(a)). If in any particular case a bank has exercised good faith and ordinary care and is relieved of responsibility by reason of instructions of or an agreement with its transferor, the owner of the item may still have a remedy for loss against the transferor (another bank) if such transferor has given wrongful instructions.

The rules of the section are applied only to collecting banks. Payor banks always have the problem of making proper payment of an item; whether such payment is proper should be based upon all of the rules of Articles 3 and 4 (A.C.A. § 4-3-101 et seq. and § 4-4-101 et seq.) and all of the facts of any particular case, and should not be dependent exclusively upon instructions from or an agreement with a person presenting the item.

### **Comment to § 4-204 (A.C.A. § 4-4-204)**

1. Subsection (a) (A.C.A. § 4-4-204(a)) prescribes the general standards applicable to proper sending or forwarding of items. Because of the many types of methods available and the desirability of preserving flexibility any attempt to prescribe limited or precise methods is avoided.

2. Subsection (b)(1) (A.C.A. § 4-4-204(b)(1)) codifies the practice of direct mail, express, messenger or like presentment to payor banks. The practice is now country-wide and is justified by the need for speed, the general responsibility of banks, Federal Deposit Insurance protection and other reasons.

3. Full approval of the practice of direct sending is limited to cases in which a bank is a payor. Since nonbank drawees or payors may be of unknown responsibility,

substantial risks may be attached to placing in their hands the instruments calling for payments from them. This is obviously so in the case of documentary drafts. However, in some cities practices have long existed under clearing-house procedures to forward certain types of items to certain nonbank payors. Examples include insurance loss drafts drawn by field agents on home offices. For the purpose of leaving the door open to legitimate practices of this kind, subsection (b)(3) (A.C.A. § 4-4-204(b)(3)) affirmatively approves direct sending of any item other than documentary drafts to any nonbank payor, if authorized by Federal Reserve regulation or operating circular, clearing-house rule or the like.

On the other hand subsection (b)(2) (A.C.A. § 4-4-204(b)(2)) approves sending



any item directly to a nonbank payor if authorized by a collecting bank's transferor. This permits special instructions or agreements out of the norm and is consistent with the "chain of command" theory of Section 4-203 (A.C.A. § 4-4-203). However, if a transferor other than the owner of the item, e.g., a prior collecting bank, authorizes a direct sending to a nonbank payor, such transferor assumes responsibility for the propriety or impropriety of such authorization.

4. Section 3-501(b) (A.C.A. § 4-3-501(b)) provides where presentment may be made. This provision is expressly subject to Article 4 (A.C.A. § 4-4-101 et seq.). Section 4-204(c) (A.C.A. § 4-4-204(c)) specifically approves presentment by a presenting bank at any place requested by the payor bank or other payor. The time when a check is received by a payor bank for presentment is governed by Regulation CC Section 229.36(b).

#### **Comment to § 4-205 (A.C.A. § 4-4-205)**

Section 3-201(b) (A.C.A. § 4-3-201(b)) provides that negotiation of an instrument payable to order requires indorsement by the holder. The rule of former Section 4-205(1) was that the depository bank may supply a missing indorsement of its customer unless the item contains the words "payee's indorsement required" or the like. The cases have differed on the status of the depository bank as a holder if it fails to supply its customer's indorsement. *Marine Midland Bank, N.A. v. Price, Miller, Evans & Flowers*, 446 N.Y.S.2d 797 (N.Y.App.Div.4th Dept. 1981), rev'd, 455 N.Y.S.2d 565 (N.Y.1982). It is common practice for depository banks to receive unindorsed checks under so-called "lock-box" agreements from customers who receive a high volume of checks. No function would be served by requiring a depository bank to run these items

through a machine that would supply the customer's indorsement except to afford the drawer and the subsequent banks evidence that the proceeds of the item reached the customer's account. Paragraph (1) (A.C.A. § 4-4-205(1)) provides that the depository bank becomes a holder when it takes the item for deposit if the depositor is a holder. Whether it supplies the customer's indorsement is immaterial. Paragraph (2) (A.C.A. § 4-4-205(2)) satisfies the need for a receipt of funds by the depository bank by imposing on that bank a warranty that it paid the customer or deposited the item to the customer's account. This warranty runs not only to collecting banks and to the payor bank or nonbank drawee but also to the drawer, affording protection to these parties that the depository bank received the item and applied it to the benefit of the holder.

#### **Comment to § 4-206 (A.C.A. § 4-4-206)**

This section (A.C.A. § 4-4-206) is designed to permit the simplest possible form of transfer from one bank to another, once an item gets in the bank collection chain, provided only identity of the transferor bank is preserved. This is important for tracing purposes and if recourse is necessary. However, since the responsibilities of the various banks appear in the

Article (Chapter)(A.C.A. § 4-4-101 et seq.) it becomes unnecessary to have liability or responsibility depend on more formal indorsements. Simplicity in the form of transfer is conducive to speed. If the transfer is between banks, this section takes the place of the more formal requirements of Section 3-201 (A.C.A. § 4-3-201).

#### **Comment to § 4-207 (A.C.A. § 4-4-207)**

Except for subsection (b) (A.C.A. § 4-4-207(b)), this section (A.C.A. § 4-4-207) conforms to Section 3-416 (A.C.A. § 4-3-416) and extends its coverage to items. The substance of this section is (A.C.A. § 4-4-207) discussed in the Comment to

Section 3-416 (A.C.A. § 4-3-416). Subsection (b) (A.C.A. § 4-4-207(b)) provides that customers or collecting banks that transfer items, whether by indorsement or not, undertake to pay the item if the item is dishonored. This obligation cannot be

disclaimed by a "without recourse" indorsement or otherwise. With respect to checks, Regulation CC Section 229.34

states the warranties made by paying and returning banks.

#### **Comment to § 4-208 (A.C.A. § 4-4-208)**

This section (A.C.A. § 4-4-208) conforms to Section 3-417 (A.C.A. § 4-3-417) and extends its coverage to items. The substance of this section (A.C.A. § 4-4-208) is discussed in the Comment to Section 3-417 (A.C.A. § 4-3-417). "Draft" is defined in Section 4-104 (A.C.A. § 4-4-

104) as including an item that is an order to pay so as to make clear that the term "draft" in Article 4 (A.C.A. § 4-4-101 et seq.) may include items that are not instruments within Section 3-104 (A.C.A. § 4-3-104).

#### **Comment to § 4-209 (A.C.A. § 4-4-209)**

1. Encoding and retention warranties are included in Article 4 (A.C.A. § 4-4-101 et seq.) because they are unique to the bank collection process. These warranties are breached only by the person doing the encoding or retaining the item and not by subsequent banks handling the item. Encoding and check retention may be done by customers who are payees of a large volume of checks; hence, this section imposes warranties on customers as well as banks. If a customer encodes or retains, the depository bank is also liable for any breach of this warranty.

2. A misencoding of the amount on the MICR line is not an alteration under Section 3-407(a) (A.C.A. § 4-3-407(a)) which defines alteration as changing the contract of the parties. If a drawer wrote a check for \$2,500 and the depository bank encoded \$25,000 on the MICR line, the payor bank could debit the drawer's account for only \$2,500. This subsection (A.C.A. § 4-3-407(a)) would allow the payor bank to hold the depository bank liable for the amount paid out over \$2,500 without first pursuing the person who received payment. Intervening collecting banks would not be liable to the payor bank for the depository bank's error. If a drawer wrote a check for \$25,000 and the

depository bank encoded \$2,500, the payor bank becomes liable for the full amount of the check. The payor bank's rights against the depository bank depend on whether the payor bank has suffered a loss. Since the payor bank can debit the drawer's account for \$25,000, the payor bank has a loss only to the extent that the drawer's account is less than the full amount of the check. There is no requirement that the payor bank pursue collection against the drawer beyond the amount in the drawer's account as a condition to the payor bank's action against the depository bank for breach of warranty. See *Georgia Railroad Bank & Trust Co. v. First National Bank & Trust*, 229 S.E.2d 482 (Ga.App.1976), *aff'd*, 235 S.E.2d 1 (Ga.1977), and *First National Bank of Boston v. Fidelity Bank, National Association*, 724 F.Supp. 1168 (E.D.Pa.1989).

3. A person retaining items under an electronic presentment agreement (Section 4-110) (A.C.A. § 4-4-110) warrants that it has complied with the terms of the agreement regarding its possession of the item and its sending a proper presentment notice. If the keeper is a customer, its depository bank also makes this warranty.

#### **Comment to § 4-210 (A.C.A. § 4-4-210)**

1. Subsection (a) (A.C.A. § 4-4-210(a)) states a rational rule for the interest of a bank in an item. The customer of the depository bank is normally the owner of the item and the several collecting banks are agents of the customer (Section 4-201) (A.C.A. § 4-4-201). A collecting agent may

properly make advances on the security of paper held for collection, and acquires at common law a possessory lien for these advances. Subsection (a) (A.C.A. § 4-4-210(a)) applies an analogous principle to a bank in the collection chain which extends credit on items in the course of collection.



The bank has a security interest to the extent stated in this section. To the extent of its security interest it is a holder for value (Sections 3-303, 4-211) (A.C.A. §§ 4-3-303 and 4-4-211) and a holder in due course if it satisfies the other requirements for that status (Section 3-302) (A.C.A. § 4-3-302). Subsection (a) (A.C.A. § 4-4-210(a)) does not derogate from the banker's general common law lien or right of setoff against indebtedness owing in deposit accounts. See Section 1-103 (A.C.A. § 4-1-103). Rather subsection (a) (A.C.A. § 4-4-210(a)) specifically implements and extends the principle as a part of the bank collection process.

2. Subsection (b) (A.C.A. § 4-4-210(b))

spreads the security interest of the bank over all items in a single deposit or received under a single agreement and a single giving of credit. It also adopts the "first-in, first-out" rule.

3. Collection statistics establish that the vast majority of items handled for collection are in fact collected. The first sentence of subsection (c) (A.C.A. § 4-4-210(c)) reflects the fact that in the normal case the bank's security interest is self-liquidating. The remainder of the subsection correlates the security interest with the provisions of Article 9 (A.C.A. § 4-9-101 et seq.), particularly for use in the cases of noncollection in which the security interest may be important.

#### **Comment to § 4-211 (A.C.A. § 4-4-211)**

The section (A.C.A. § 4-4-211) completes the thought of the previous section and makes clear that a security interest in an item is "value" for the purpose of determining the holder's status as a holder in due course. The provision is in accord with the prior law (N.I.L. Section 27) and with Article 3 (A.C.A. § 4-3-101 et seq.) (Sec-

tion 3-303) (A.C.A. § 4-3-303). The section (A.C.A. § 4-4-211) does not prescribe a security interest under Section 4-210 (A.C.A. § 4-4-210) as a test of "value" generally because the meaning of "value" under other Articles (Chapters) is adequately defined in Section 1-201 (A.C.A. § 4-1-201).

#### **Comment to § 4-212 (A.C.A. § 4-4-212)**

1. This section (A.C.A. § 4-4-212) codifies a practice extensively followed in presentation of trade acceptances and documentary and other drafts drawn on nonbank payors. It (A.C.A. § 4-4-212) imposes a duty on the payor to respond to the notice of the item if the item is not to be considered dishonored. Notice of such a dishonor charges drawers and indorsers. Presentment under this section is good presentment under Article 3 (A.C.A. § 4-

3-101 et seq.). See Section 3-501 (A.C.A. § 4-3-501).

2. A drawee not receiving notice is not, of course, liable to the drawer for wrongful dishonor.

3. A bank so presenting an instrument must be sufficiently close to the drawee to be able to exhibit the instrument on the day it is requested to do so or the next business day at the latest.

#### **Comment to § 4-213 (A.C.A. § 4-4-213)**

1. Subsection (a) (A.C.A. § 4-4-213(a)) sets forth the medium of settlement that the person receiving settlement must accept. In nearly all cases the medium of settlement will be determined by agreement or by Federal Reserve regulations and circulars, clearing-house rules, and the like. In the absence of regulations, rules or agreement, the person receiving settlement may demand cash or credit in a Federal Reserve bank. If the person receiving settlement does not have an ac-

count in a Federal Reserve bank, it may specify the account of another bank in a Federal Reserve bank. In the unusual case in which there is no agreement on the medium of settlement and the bank making settlement tenders settlement other than cash or Federal Reserve bank credit, no settlement has occurred under subsection (b) (A.C.A. § 4-4-213(b)) unless the person receiving settlement accepts the settlement tendered. For example, if a payor bank, without agreement, tenders a

teller's check, the bank receiving the settlement may reject the check and return it to the payor bank or it may accept the check as settlement.

2. In several provisions of Article 4 (A.C.A. § 4-4-101 et seq.) the time that a settlement occurs is relevant. Subsection (a) (A.C.A. § 4-4-213(a)) sets out a general rule that the time of settlement, like the means of settlement, may be prescribed by agreement. In the absence of agreement, the time of settlement for tender of the common agreed media of settlement is that set out in subsection (a)(2) (A.C.A. § 4-4-213(a)(2)). The time of settlement by cash, cashier's or teller's check or authority to charge an account is the time the cash, check or authority is sent, unless presentment is over the counter in which case settlement occurs upon delivery to the presenter. If there is no agreement on the time of settlement and the tender of settlement is not made by one of the media set out in subsection (a) (A.C.A. § 4-4-213(a)), under subsection (b) (A.C.A. § 4-4-213(b)) the time of settlement is the time the settlement is accepted by the person receiving settlement.

3. Subsections (c) and (d) (A.C.A. § 4-4-213(c) and (d)) are special provisions for settlement by remittance drafts and authority to charge an account in the bank receiving settlement. The relationship between final settlement and final payment under Section 4-215 (A.C.A. § 4-4-215) is addressed in subsection (b) of Section 4-215 (A.C.A. § 4-4-215(b)). With respect to settlement by cashier's checks or teller's checks, other than in response to

over-the-counter presentment, the bank receiving settlement can keep the risk that the check will not be paid on the bank tendering the check in settlement by acting to initiate collection of the check within the midnight deadline of the bank receiving settlement. If the bank fails to initiate settlement before its midnight deadline, final settlement occurs at the midnight deadline, and the bank receiving settlement assumes the risk that the check will not be paid. If there is no agreement that permits the bank tendering settlement to tender a cashier's or teller's check, subsection (b) (A.C.A. § 4-4-213(b)) allows the bank receiving the check to reject it, and, if it does, no settlement occurs. However, if the bank accepts the check, settlement occurs and the time of final settlement is governed by subsection (c) (A.C.A. § 4-4-213(c)).

With respect to settlement by tender of authority to charge the account of the bank making settlement in the bank receiving settlement, subsection (d) (A.C.A. § 4-4-213(d)) provides that final settlement does not take place until the account charged has available funds to cover the amount of the item. If there is no agreement that permits the bank tendering settlement to tender an authority to charge an account as settlement, subsection (b) (A.C.A. § 4-4-213(b)) allows the bank receiving the tender to reject it. However, if the bank accepts the authority, settlement occurs and the time of final settlement is governed by subsection (d) (A.C.A. § 4-4-213(d)).

### Comment to § 4-214 (A.C.A. § 4-4-214)

1. Under current bank practice, in a major portion of cases banks make provisional settlement for items when they are first received and then await subsequent determination of whether the item will be finally paid. This is the principal characteristic of what are referred to in banking parlance as "cash items." Statistically, this practice of settling provisionally first and then awaiting final payment is justified because the vast majority of such cash items are finally paid, with the result that in this great preponderance of cases it becomes unnecessary for the banks making the provisional settlements to make any further entries. In due course the

provisional settlements become final simply with the lapse of time. However, in those cases in which the item being collected is not finally paid or if for various reasons the bank making the provisional settlement does not itself receive final payment, provision is made in subsection (a) (A.C.A. § 4-4-214(a)) for the reversal of the provisional settlements, charge-back of provisional credits and the right to obtain refund.

2. Various causes of a bank's not receiving final payment, with the resulting right of charge-back or refund, are stated or suggested in subsection (a) (A.C.A. § 4-4-214(a)). These include dishonor of the



original item; dishonor of a remittance instrument given for it; reversal of a provisional credit for the item; suspension of payments by another bank. The causes stated are illustrative; the right of charge-back or refund is stated to exist whether the failure to receive final payment in ordinary course arises through one of them or "otherwise."

3. The right of charge-back or refund exists if a collecting bank has made a provisional settlement for an item with its customer but terminates if and when a settlement received by the bank for the item is or becomes final. If the bank fails to receive such a final settlement the right of charge-back or refund must be exercised promptly after the bank learns the facts. The right exists (if so promptly exercised) whether or not the bank is able to return the item. The second sentence of subsection (a) (A.C.A. § 4-4-214(a)) adopts the view of *Appliance Buyers Credit Corp. v. Prospect National Bank*, 708 F.2d 290 (7th Cir.1983), that if the midnight deadline for returning an item or giving notice is not met, a collecting bank loses its rights only to the extent of damages for any loss resulting from the delay.

4. Subsection (b) (A.C.A. § 4-4-214(b)) states when an item is returned by a collecting bank. Regulation CC, Section 229.31 preempts this subsection with respect to checks by allowing direct return to the depository bank. Because a returned check may follow a different path than in forward collection, settlement given for the check is final and not provisional except as between the depository bank and its customer. Regulation CC Section 229.36(d). See also Regulations CC Sections 229.31(c) and 229.32(b). Thus

owing to the federal preemption, this subsection applies only to noncheck items.

5. The rule of subsection (d) (A.C.A. § 4-4-214(d)) relating to charge-back (as distinguished from claim for refund) applies irrespective of the cause of the nonpayment, and of the person ultimately liable for nonpayment. Thus charge-back is permitted even if nonpayment results from the depository bank's own negligence. Any other rule would result in litigation based upon a claim for wrongful dishonor of other checks of the customer, with potential damages far in excess of the amount of the item. Any other rule would require a bank to determine difficult questions of fact. The customer's protection is found in the general obligation of good faith (Sections 1-203 and 4-103) (A.C.A. §§ 4-1-203 and 4-4-103). If bad faith is established the customer's recovery "includes other damages, if any, suffered by the party as a proximate consequence" (Section 4-103(e); see also Section 4-402) (A.C.A. § 4-4-103(e); see also A.C.A. § 4-4-402).

6. It is clear that the charge-back does not relieve the bank from any liability for failure to exercise ordinary care in handling the item. The measure of damages for such failure is stated in Section 4-103(e) (A.C.A. § 4-4-103(e)).

7. Subsection (f) (A.C.A. § 4-4-214(f)) states a rule fixing the time for determining the rate of exchange if there is a charge-back or refund of a credit given in dollars for an item payable in a foreign currency. Compare Section 3-107 (A.C.A. § 4-3-107). Fixing such a rule is desirable to avoid disputes. If in any case the parties wish to fix a different time for determining the rate of exchange, they may do so by agreement.

### Comment to § 4-215 (A.C.A. § 4-4-215)

1. By the definition and use of the term "settle" (Section 4-104(a)(11)) (A.C.A. § 4-4-104(a)(11)) this Article (Chapter) (A.C.A. § 4-4-101 et seq.) recognizes that various debits or credits, remittances, settlements or payments given for an item may be either provisional or final, that settlements sometimes are provisional and sometimes are final and sometimes are provisional for awhile but later become final. Subsection (a) (A.C.A. § 4-4-

215(a)) defines when settlement for an item constitutes final payment.

Final payment of an item is important for a number of reasons. It is one of several factors determining the relative priorities between items and notices, stop-payment orders, legal process and setoffs (Section 4-303) (A.C.A. § 4-4-303). It is the "end of the line" in the collection process and the "turn around" point commencing the return flow of proceeds. It is

the point at which many provisional settlements become final. See Section 4-215(c) (A.C.A. § 4-4-215(c)). Final payment of an item by the payor bank fixes preferential rights under Section 4-216 (A.C.A. § 4-4-216).

2. If an item being collected moves through several states, e.g., is deposited for collection in California, moves through two or three California banks to the Federal Reserve Bank of San Francisco, to the Federal Reserve Bank of Boston, to a payor bank in Maine, the collection process involves the eastward journey of the item from California to Maine and the westward journey of the proceeds from Maine to California. Subsection (a) (A.C.A. § 4-4-215(a)) recognizes that final payment does not take place, in this hypothetical case, on the journey of the item eastward. It also adopts the view that neither does final payment occur on the journey westward because what in fact is journeying westward are *proceeds* of the item.

3. Traditionally and under various decisions payment in cash of an item by a payor bank has been considered final payment. Subsection (a)(1) (A.C.A. § 4-4-215(a)(1)) recognizes and provides that payment of an item in cash by a payor bank is final payment.

4. Section 4-104(a)(11) (A.C.A. § 4-4-104(a)(11)) defines "settle" as meaning "to pay in cash, by clearing-house settlement, in a charge or credit or by remittance, or otherwise as agreed. A settlement may be either provisional or final." Subsection (a)(2) of Section 4-215 (A.C.A. § 4-4-215(a)(2)) provides that an item is finally paid by a payor bank when the bank has "settled for the item without having a right to revoke the settlement under statute, clearing-house rule or agreement." Former subsection (1)(b) is modified by subsection (a)(2) (A.C.A. § 4-4-215(a)(2)) to make clear that a payor bank cannot make settlement provisional by unilaterally reserving a right to revoke the settlement. The right must come from a statute (e.g., Section 4-301) (A.C.A. § 4-4-301), clearing-house rule or other agreement. Subsection (a)(2) (A.C.A. § 4-4-215(a)(2)) provides in effect that if the payor bank finally settles for an item this constitutes final payment of the item. The subsection operates if nothing has occurred and no situation exists making the settlement

provisional. If under statute, clearing-house rule or agreement, a right of revocation of the settlement exists, the settlement is provisional. Conversely, if there is an absence of a right to revoke under statute, clearing-house rule or agreement, the settlement is final and such final settlement constitutes final payment of the item.

A primary example of a statutory right on the part of the payor bank to revoke a settlement is the right to revoke conferred by Section 4-301 (A.C.A. § 4-4-301). The underlying theory and reason for deferred posting statutes (Section 4-301) (A.C.A. § 4-4-301) is to require a settlement on the date of receipt of an item but to keep that settlement provisional with the right to revoke prior to the midnight deadline. In any case in which Section 4-301 (A.C.A. § 4-4-301) is applicable, any settlement by the payor bank is provisional solely by virtue of the statute, subsection (a)(2) of Section 4-215 (A.C.A. § 4-4-215(a)(2)) does not operate, and such provisional settlement does not constitute final payment of the item. With respect to checks, Regulation CC Section 229.36(d) provides that settlement between banks for the forward collection of checks is final. The relationship of this provision to Article 4 (A.C.A. § 4-4-101 et seq.) is discussed in the Commentary to that section.

A second important example of a right to revoke a settlement is that arising under clearing-house rules. It is very common for clearing-house rules to provide that items exchanged and settled for in a clearing (e.g., before 10:00 a.m. on Monday) may be returned and the settlements revoked up to but not later than 2:00 p.m. on the same day (Monday) or under deferred posting at some hour on the next business day (e.g., 2:00 p.m. Tuesday). Under this type of rule the Monday morning settlement is provisional and being provisional does not constitute a final payment of the item.

An example of an agreement allowing the payor bank to revoke a settlement is a case in which the payor bank is also the depository bank and has signed a receipt or duplicate deposit ticket or has made an entry in a passbook acknowledging receipt, for credit to the account of A, of a check drawn on it by B. If the receipt, deposit ticket, passbook or other agreement with A is to the effect that any credit



so entered is provisional and may be revoked pending the time required by the payor bank to process the item to determine if it is in good form and there are funds to cover it, the agreement keeps the receipt or credit provisional and avoids its being either final settlement or final payment.

The most important application of subsection (a)(2) (A.C.A. § 4-4-215(a)(2)) is that in which presentment of an item has been made over the counter for immediate payment. In this case Section 4-301(a) (A.C.A. § 4-4-301(a)) does not apply to make the settlement provisional, and final payment has occurred unless a rule or agreement provides otherwise.

5. Former Section 4-213(1)(c) provided that final payment occurred when the payor bank completed the "process of posting." The term was defined in former Section 4-109. In the present Article (Chapter), Section 4-109 has been deleted and the process-of-posting test has been abandoned in Section 4-215(a) (A.C.A. § 4-4-215(a)) for determining when final payment is made. Difficulties in determining when the events described in former Section 4-109 take place make the process-of-posting test unsuitable for a system of automated check collection or electronic presentment.

6. The last sentence of former Section 4-213(1) is deleted as an unnecessary source of confusion. Initially the view that payor bank may be accountable for, that is, liable for the amount of, an item that it has already paid seems incongruous. This is particularly true in the light of the language formerly found in Section 4-302 stating that the payor bank can defend against liability for accountability by showing that it has already settled for the item. But, at least with respect to former Section 4-213(1)(c), such a provision was needed because under the process-of-posting test a payor bank may have paid an item without settling for it. Now that Article 4 (A.C.A. § 4-4-101 et seq.) has abandoned the process-of-posting test, the sentence is no longer needed. If the payor bank has neither paid the item nor returned it within its midnight deadline, the payor bank is accountable under Section 4-302 (A.C.A. § 4-4-302).

7. Subsection (a)(3) (A.C.A. § 4-4-215(a)(3)) covers the situation in which the payor bank makes a provisional set-

tlement for an item, and this settlement becomes final at a later time by reason of the failure of the payor bank to revoke it in the time and manner permitted by statute, clearing-house rule or agreement. An example of this type of situation is the clearing-house settlement referred to in Comment 4. In the illustration there given if the time limit for the return of items received in the Monday morning clearing is 2:00 p.m. on Tuesday and the provisional settlement has not been revoked at that time in a manner permitted by the clearing-house rules, the provisional settlement made on Monday morning becomes final at 2:00 p.m. on Tuesday. Subsection (a)(3) (A.C.A. § 4-4-215(a)(3)) provides specifically that in this situation the item is finally paid at 2:00 p.m. Tuesday. If on the other hand a payor bank receives an item in the mail on Monday and makes some provisional settlement for the item on Monday, it has until midnight on Tuesday to return the item or give notice and revoke any settlement under Section 4-301 (A.C.A. § 4-4-301). In this situation subsection (a)(3) of Section 4-215 (A.C.A. § 4-4-215(a)(3)) provides that if the provisional settlement made on Monday is not revoked before midnight on Tuesday as permitted by Section 4-301 (A.C.A. § 4-4-301), the item is finally paid at midnight on Tuesday. With respect to checks, Regulation CC Section 229.30(c) allows an extension of the midnight deadline under certain circumstances. If a bank does not expeditiously return a check liability may accrue under Regulation CC Section 229.38. For the relationship of that liability to responsibility under this Article (Chapter) (A.C.A. § 4-4-101 et seq.), see Regulation CC Sections 229.30 and 229.38.

8. Subsection (b) (A.C.A. § 4-4-215(b)) relates final settlement to final payment under Section 4-215 (A.C.A. § 4-4-215). For example, if a payor bank makes provisional settlement for an item by sending a cashier's or teller's check and that settlement fails to become final under Section 4-213(c) (A.C.A. § 4-4-213(c)), subsection (b) (A.C.A. § 4-4-215(b)) provides that final payment has not occurred. If the item is not paid, the drawer remains liable, and under Section 4-302(a) (A.C.A. § 4-4-302(a)) the payor bank is accountable unless it has returned the item before its midnight deadline. In this regard, sub-

section (b) (A.C.A. § 4-4-215(b)) is an exception to subsection (a)(3) (A.C.A. § 4-4-215(a)(3)). Even if the payor bank has not returned an item by its midnight deadline there is still no final payment if provisional settlement has been made and settlement failed to become final. However, if presentment of the item was over the counter for immediate payment, final payment has occurred under Section 4-215(a)(2) (A.C.A. § 4-4-215(a)(2)). Subsection (b) (A.C.A. § 4-4-215(b)) does not apply because the settlement was not provisional. Section 4-301(a) (A.C.A. § 4-4-301(a)). In this case the presenting person, often the payee of the item, has the right to demand cash or the cash equivalent of federal reserve credit. If the presenting person accepts another medium of settlement such as a cashier's or teller's check, the presenting person takes the risk that the payor bank may fail to pay a cashier's check because of insolvency or that the drawee of a teller's check may dishonor it.

9. Subsection (c) (A.C.A. § 4-4-215(c)) states the country-wide usage that when the item is finally paid by the payor bank under subsection (a) (A.C.A. § 4-4-215(a)) this final payment automatically without further action "firms up" other provisional settlements made for it. However, the subsection (A.C.A. § 4-4-215(c)) makes clear that this "firming up" occurs only if the settlement between the presenting and payor banks was made either through a clearing house or by debits and credits in accounts between them. It does not take place if the payor bank remits for the item by sending some form of remittance instrument. Further, the "firming up" continues only to the extent that provisional debits and credits are entered seriatim in accounts between banks which are successive to the presenting bank. The automatic "firming up" is broken at any time that any collecting bank remits for the item by sending a remittance draft, because final payment to the remittee then usually depends upon final payment of the remittance draft.

10. Subsection (d) (A.C.A. § 4-4-215(d)) states the general rule that if a collecting bank receives settlement for an item which is or becomes final, the bank is accountable to its customer for the amount of the item. One means of accounting is to remit to its customer the

amount it has received on the item. If previously it gave to its customer a provisional credit for the item in an account its receipt of final settlement for the item "firms up" this provisional credit and makes it final. When this credit given by it so becomes final, in the usual case its agency status terminates and it becomes a debtor to its customer for the amount of the item. See Section 4-201(a) (A.C.A. § 4-4-201(a)). If the accounting is by a remittance instrument or authorization to charge further time will usually be required to complete its accounting (Section 4-213) (A.C.A. § 4-4-213).

11. Subsection (e) (A.C.A. § 4-4-215(e)) states when certain credits given by a bank to its customer become available for withdrawal as of right. Subsection (e)(1) (A.C.A. § 4-4-215(e)(1)) deals with the situation in which a bank has given a credit (usually provisional) for an item to its customer and in turn has received a provisional settlement for the item from an intermediary or payor bank to which it has forwarded the item. In this situation before the provisional credit entered by the collecting bank in the account of its customer becomes available for withdrawal as of right, it is not only necessary that the provisional settlement received by the bank for the item becomes final but also that the collecting bank has a reasonable time to receive return of the item and the item has not been received within that time. How much time is "reasonable" for these purposes will of course depend on the distance the item has to travel and the number of banks through which it must pass (having in mind not only travel time by regular lines of transmission but also the successive midnight deadlines of the several banks) and other pertinent facts. Also, if the provisional settlement received is some form of a remittance instrument or authorization to charge, the "reasonable" time depends on the identity and location of the payor of the remittance instrument, the means for clearing such instrument, and other pertinent facts. With respect to checks Regulation CC Sections 229.10—229.13 or similar applicable state law (Section 229.20) control. This is also time for the situation described in Comment 12.

12. Subsection (e)(2) (A.C.A. § 4-4-215(e)(2)) deals with the situation of a bank that is both a depository bank and a



payor bank. The subsection recognizes that if A and B are both customers of a depository-payor bank and A deposits B's check on the depository-payor in A's account on Monday, time must be allowed to permit the check under the deferred posting rules of Section 4-301 (A.C.A. § 4-4-301) to reach the bookkeeper for B's account at some time on Tuesday, and, if there are insufficient funds in B's account, to reverse or charge back the provisional credit in A's account. Consequently this provisional credit in A's account does not

become available for withdrawal as of right until the opening of business on Wednesday. If it is determined on Tuesday that there are insufficient funds in B's account to pay the check, the credit to A's account can be reversed on Tuesday. On the other hand if the item is in fact paid on Tuesday, the rule of subsection (e)(2) (A.C.A. § 4-4-215(e)(2)) is desirable to avoid uncertainty and possible disputes between the bank and its customer as to exactly what hour within the day the credit is available.

### Comment to § 4-216 (A.C.A. § 4-4-216)

The underlying purpose of the provisions of this section (A.C.A. § 4-4-216) is not to confer upon banks, holders of items or anyone else preferential positions in the event of bank failures over general depositors or any other creditors of the failed banks. The purpose is to fix as definitely as possible the cut-off point of time for the completion or cessation of the collection process in the case of items that happen to be in the process at the time a particular bank suspends payments. It must be remembered that in bank collections as a whole and in the handling of items by an individual bank, items go through a whole series of processes. It must also be remembered that at any particular point of time a particular bank (at least one of any size) is functioning as a depository bank for some items, as an intermediary bank for others, as a presenting bank for still others and as a payor bank for still others, and that when it suspends payments it will have close to its normal load of items working through its various processes. For the convenience of receivers, owners of items, banks, and in fact substantially everyone concerned, it is recognized that at the particular moment of time that a bank suspends payment, a certain portion of the items being handled by it have progressed far enough in the bank collection process that it is preferable to permit them to continue the remaining distance, rather than to send them back and reverse the many entries that have been made or the steps that have been taken with respect to

them. Therefore, having this background and these purposes in mind, the section (A.C.A. § 4-4-216) states what items must be turned backward at the moment suspension intervenes and what items have progressed far enough that the collection process with respect to them continues, with the resulting necessary statement of rights of various parties flowing from this prescription of the cut-off time.

2. The rules stated are similar to those stated in the American Bankers Association Bank Collection Code, but with the abandonment of any theory of trust. On the other hand, some law previous to this Act (A.C.A. § 4-4-101 et seq.) may be relevant. See Note, Uniform Commercial Code: Stopping Payment of an Item Deposited with an Insolvent Depository Bank, 40 Okla.L.Rev. 689 (1987). Although for practical purposes Federal Deposit Insurance affects materially the result of bank failures on holders of items and banks, no attempt is made to vary the rules of the section by reason of such insurance.

3. It is recognized that in view of *Jennings v. United States Fidelity & Guaranty Co.*, 294 U.S. 216, 55 S.Ct. 394, 79 L.Ed. 869, 99 A.L.R. 1248 (1935), amendment of the National Bank Act would be necessary to have this section (A.C.A. § 4-4-216) apply to national banks. But there is no reason why it (A.C.A. § 4-4-216) should not apply to others. See Section 1-108 (A.C.A. § 4-1-108).

**Comment to § 4-301 (A.C.A. § 4-4-301)**

1. The term “deferred posting” appears in the caption of Section 4-301 (A.C.A. § 4-4-301). This refers to the practice permitted by statute in most of the states before the UCC (A.C.A. § 4-1-101 et seq.) under which a payor bank receives items on one day but does not post the items to the customer’s account until the next day. Items dishonored were then returned after the posting on the day after receipt. Under Section 4-301 (A.C.A. § 4-4-301) the concept of “deferred posting” merely allows a payor bank that has settled for an item on the day of receipt to return a dishonored item on the next day before its midnight deadline, without regard to when the item was actually posted. With respect to checks Regulation CC Section 229.30(c) extends the midnight deadline under the UCC (A.C.A. § 4-1-101 et seq.) under certain circumstances. See the Commentary to Regulation CC Section 229.38(d) on the relationship between the UCC (A.C.A. § 4-1-101 et seq.) and Regulation CC on settlement.

2. The function of this section is to provide the circumstances under which a payor bank that has made timely settlement for an item may return the item and revoke the settlement so that it may recover any settlement made. These circumstances are: (1) the item must be a demand item other than a documentary draft; (2) the item must be presented otherwise than for immediate payment over the counter; and (3) the payor bank must return the item (or give notice if the item is unavailable for return) before its midnight deadline and before it has paid the item. With respect to checks, see Regulation CC Section 229.31(f) on notice in lieu of return and Regulation CC Section 229.33 as to the different requirement of notice of nonpayment. An instance of when an item may be unavailable for return arises under a collecting bank check retention plan under which presentment is made by a presentment notice and the item is retained by the collecting bank. Section 4-215(a)(2) (A.C.A. § 4-4-215(a)(2)) provides that final payment occurs if the payor bank has settled for an item without a right to revoke the settlement under statute, clearing-house rule or agreement. In any case in which Sec-

tion 4-301(a) (A.C.A. § 4-4-301(a)) is applicable, the payor bank has a right to revoke the settlement by statute; therefore, Section 4-215(a)(2) (A.C.A. § 4-4-215(a)(2)) is inoperable, and the settlement is provisional. Hence, if the settlement is not over the counter and the payor bank settles in a manner that does not constitute final payment, the payor bank can revoke the settlement by returning the item before its midnight deadline.

3. The relationship of Section 4-301(a) (A.C.A. § 4-4-301(a)) to final settlement and final payment under Section 4-215 (A.C.A. § 4-4-215) is illustrated by the following case. Depository Bank sends by mail an item to Payor Bank with instructions to settle by remitting a teller’s check drawn on a bank in the city where Depository Bank is located. Payor Bank sends the teller’s check on the day the item was presented. Having made timely settlement, under the deferred posting provisions of Section 4-301(a) (A.C.A. § 4-4-301(a)), Payor Bank may revoke that settlement by returning the item before its midnight deadline. If it fails to return the item before its midnight deadline, it has finally paid the item if the bank on which the teller’s check was drawn honors the check. But if the teller’s check is dishonored there has been no final settlement under Section 4-213(c) (A.C.A. § 4-4-213(c)) and no final payment under Section 4-215(b) (A.C.A. § 4-4-215(b)). Since the Payor Bank has neither paid the item nor made timely return, it is accountable for the item under Section 4-302(a) (A.C.A. § 4-4-302(a)).

4. The time limits for action imposed by subsection (a) (A.C.A. § 4-4-301(a)) are adopted by subsection (b) (A.C.A. § 4-4-301(b)) for cases in which the payor bank is also the depository bank, but in this case the requirement of a settlement on the day of receipt is omitted.

5. Subsection (c) (A.C.A. § 4-4-301(c)) fixes a base point from which to measure the time within which notice of dishonor must be given. See Section 3-503 (A.C.A. § 3-3-503).

6. Subsection (d) (A.C.A. § 4-4-301(d)) leaves banks free to agree upon the manner of returning items but establishes a precise time when an item is “returned.”



For definition of "sent" as used in paragraphs (1) and (2) (A.C.A. § 4-4-301(d)(1) and (2)) see Section 1-201(38) (A.C.A. § 4-1-201(38)). Obviously the subsection assumes that the item has not been "finally paid" under Section 4-215(a) (A.C.A. § 4-4-215(a)). If it has been, this provision has no operation.

7. The fact that an item has been paid

under proposed Section 4-215 (A.C.A. § 4-4-215) does not preclude the payor bank from asserting rights of restitution or revocation under Section 3-418 (A.C.A. § 3-418). *National Savings and Trust Co. v. Park Corp.*, 722 F.2d 1303 (6th Cir. 1983), cert. denied, 466 U.S. 939 (1984), is the correct interpretation of the present law on this issue.

### Comment to § 4-302 (A.C.A. § 4-4-302)

1. Subsection (a)(1) (A.C.A. § 4-4-302(a)(1)) continues the former law distinguishing between cases in which the payor bank is not also the depository bank and those in which the payor bank is also the depository bank ("on us" items). For "on us" items the payor bank is accountable if it retains the item beyond its midnight deadline without settling for it. If the payor bank is not the depository bank it is accountable if it retains the item beyond midnight of the banking day of receipt without settling for it. It may avoid accountability either by settling for the item on the day of receipt and returning the item before its midnight deadline under Section 4-301 (A.C.A. § 4-4-301) or by returning the item on the day of receipt. This rule is consistent with the deferred posting practice authorized by Section 4-301 (A.C.A. § 4-4-301) which allows the payor bank to make provisional settlement for an item on the day of receipt and to revoke that settlement by returning the item on the next day. With respect to checks, Regulation CC Section 229.36(d) provides that settlements between banks for forward collection of checks are final when made. See the Commentary on that provision for its effect on the UCC (A.C.A. § 4-1-101 et seq.).

2. If the settlement given by the payor bank does not become final, there has been no payment under Section 4-215(b) (A.C.A. § 4-4-215(b)), and the payor bank giving the failed settlement is accountable under subsection (a)(1) of Section 4-302 (A.C.A. § 4-4-302(a)(1)). For instance, the payor bank makes provisional settlement by sending a teller's check that is dishonored. In such a case settlement is not final under Section 4-213(c) (A.C.A. § 4-4-

213(c)) and no payment occurs under Section 4-215(b) (A.C.A. § 4-4-215(b)). Payor bank is accountable on the item. The general principle is that unless settlement provides the presenting bank with usable funds, settlement has failed and the payor bank is accountable for the amount of the item.

3. Subsection (b) (A.C.A. § 4-4-302(b)) is an elaboration of the deleted introductory language of former Section 4-302: "In the absence of a valid defense such as breach of a presentment warranty (subsection (1) of Section 4-207) (A.C.A. § 4-4-207(1)), settlement effected or the like ...." A payor bank can defend an action against it based on accountability by showing that the item contained a forged indorsement or a fraudulent alteration. Subsection (b) (A.C.A. § 4-4-302(b)) drops the ambiguous "or the like" language and provides that the payor bank may also raise the defense of fraud. Decisions that hold an accountable bank's liability to be "absolute" are rejected. A payor bank that makes a late return of an item should not be liable to a defrauder operating a check kiting scheme. In *Bank of Leumi Trust Co. v. Bally's Park Place Inc.*, 528 F.Supp. 349 (S.D.N.Y. 1981), and *American National Bank v. Foodbasket*, 497 P.2d 546 (Wyo. 1972), banks that were accountable under Section 4-302 (A.C.A. § 4-4-302) for missing their midnight deadline were successful in defending against parties who initiated collection knowing that the check would not be paid. The "settlement effected" language is deleted as unnecessary. If a payor bank is accountable for an item it is liable to pay it. If it has made final payment for an item, it is no longer accountable for the item.

**Comment to § 4-303 (A.C.A. § 4-4-303)**

1. While a payor bank is processing an item presented for payment, it may receive knowledge or a legal notice affecting the item, such as knowledge or a notice that the drawer has filed a petition in bankruptcy or made an assignment for the benefit of creditors; may receive an order of the drawer stopping payment on the item; may have served on it an attachment of the account of the drawer; or the bank itself may exercise a right of setoff against the drawer's account. Each of these events affects the account of the drawer and may eliminate or freeze all or part of whatever balance is available to pay the item. Subsection (a) (A.C.A. § 4-4-303(a)) states the rule for determining the relative priorities between these various legal events and the item.

2. The rule is that if any one of several things has been done to the item or if it has reached any one of several stages in its processing at the time the knowledge, notice, stop-payment order or legal process is received or served and a reasonable time for the bank to act thereon expires or the setoff is exercised, the knowledge, notice, stop-payment order, legal process or setoff comes too late, the item has priority and a charge to the customer's account may be made and is effective. With respect to the effect of the customer's bankruptcy, the bank's rights are governed by Bankruptcy Code Section 542(c) which codifies the result of *Bank of Marin v. England*, 385 U.S. 99 (1966). Section 4-405 (A.C.A. § 4-4-405) applies to the death or incompetence of the customer.

3. Once a payor bank has accepted or certified an item or has paid the item in cash, the event has occurred that determines priorities between the item and the various legal events usually described as the "four legals." Paragraphs (1) and (2) of subsection (a) (A.C.A. § 4-4-303(a)(1) and (2)) so provide. If a payor bank settles for an item presented over the counter for immediate payment by a cashier's check or teller's check which the presenting person agrees to accept, paragraph (3) of subsection (a) (A.C.A. § 4-4-303(a)(3)) would control and the event determining priority has occurred. Because presentment was over the counter, Section 4-301(a) (A.C.A. § 4-4-301(a)) does not

apply to give the payor bank the statutory right to revoke the settlement. Thus the requirements of paragraph (3) (A.C.A. § 4-4-303(a)(3)) have been met unless a clearing-house rule or agreement of the parties provides otherwise.

4. In the usual case settlement for checks is by entries in bank accounts. Since the process-of-posting test has been abandoned as inappropriate for automated check collection, the determining event for priorities is a given hour on the day after the item is received. (Paragraph (5) of subsection (a).) (A.C.A. § 4-4-303(a)(5)). The hour may be fixed by the bank no earlier than one hour after the opening on the next banking day after the bank received the check and no later than the close of that banking day. If an item is received after the payor bank's regular Section 4-108 (A.C.A. § 4-4-108) cutoff hour, it is treated as received the next banking day. If a bank receives an item after its regular cutoff hour on Monday and an attachment is levied at noon on Tuesday, the attachment is prior to the item if the bank had not before that hour taken the action described in paragraphs (1), (2), and (3) of subsection (a) (A.C.A. § 4-4-303(a)(1), (2), and (3)). The Commentary to Regulation CC Section 229.36(d) explains that even though settlement by a paying bank for a check is final for Regulation CC purposes, the paying bank's right to return the check before its midnight deadline under the UCC (A.C.A. § 4-1-101 et seq.) is not affected.

5. Another event conferring priority for an item and a charge to the customer's account based upon the item is stated by the language "become accountable for the amount of the item under Section 4-302 (A.C.A. § 4-4-302) dealing with the payor bank's responsibility for late return of items." Expiration of the deadline under Section 4-302 (A.C.A. § 4-4-302) with resulting accountability by the payor bank for the amount of the item, establishes priority of the item over notices, stop-payment orders, legal process or setoff.

6. In the case of knowledge, notice, stop-payment orders and legal process the effective time for determining whether they were received too late to affect the payment of an item and a charge to the



customer's account by reason of such payment, is receipt plus a reasonable time for the bank to act on any of these communications. Usually a relatively short time is required to communicate to the accounting department advice of one of these events but certainly some time is necessary. Compare Sections 1-201(27) and 4-403 (A.C.A. §§ 4-1-201(27) and 4-4-403). In the case of setoff the effective time is when the setoff is actually made.

7. As between one item and another no priority rule is stated. This is justified because of the impossibility of stating a rule that would be fair in all cases, having in mind the almost infinite number of combinations of large and small checks in

relation to the available balance on hand in the drawer's account; the possible methods of receipt; and other variables. Further, the drawer has drawn all the checks, the drawer should have funds available to meet all of them and has no basis for urging one should be paid before another; and the holders have no direct right against the payor bank in any event, unless of course, the bank has accepted, certified or finally paid a particular item, or has become liable for it under Section 4-302 (A.C.A. § 4-4-302). Under subsection (b) (A.C.A. § 4-4-303(b)) the bank has the right to pay items for which it is itself liable ahead of those for which it is not.

#### **Comment to § 4-401 (A.C.A. § 4-4-401)**

1. An item is properly payable from a customer's account if the customer has authorized the payment and the payment does not violate any agreement that may exist between the bank and its customer. For an example of a payment held to violate an agreement with a customer, see *Torrance National Bank v. Enesco Federal Credit Union*, 285 P.2d 737 (Cal.App. 1955). An item drawn for more than the amount of a customer's account may be properly payable. Thus under subsection (a) (A.C.A. § 4-4-401(a)) a bank may charge the customer's account for an item even though payment results in an overdraft. An item containing a forged drawer's signature or forged indorsement is not properly payable. Concern has arisen whether a bank may require a customer to execute a stop-payment order when the customer notifies the bank of the loss of an undorsed or specially indorsed check. Since such a check cannot be properly payable from the customer's account, it is inappropriate for a bank to require stop-payment order in such a case.

2. Subsection (b) (A.C.A. § 4-4-401(b)) adopts the view of case authority holding that if there is more than one customer who can draw on an account, the nonsigning customer is not liable for an overdraft unless that person benefits from the proceeds of the item.

3. Subsection (c) (A.C.A. § 4-4-401(c)) is added because the automated check collection system cannot accommodate postdated checks. A check is usually paid

upon presentment without respect to the date of the check. Under the former law, if a payor bank paid a postdated check before its stated date, it could not charge the customer's account because the check was not "properly payable." Hence, the bank might have been liable for wrongfully dishonoring subsequent checks of the drawer that would have been paid had the postdated check not been prematurely paid. Under subsection (c) (A.C.A. § 4-4-401(c)) a customer wishing to postdate a check must notify the payor bank of its postdating in time to allow the bank to act on the customer's notice before the bank has to commit itself to pay the check. If the bank fails to act on the customer's timely notice, it may be liable for damages for the resulting loss which may include damages for dishonor of subsequent items. This Act (A.C.A. § 4-4-101 et seq.) does not regulate fees that banks charge their customers for a notice of postdating or other services covered by the Act (A.C.A. § 4-4-101 et seq.), but under principles of law such as unconscionability or good faith and fair dealing, courts have reviewed fees and the bank's exercise of a discretion to set fees. *Perdue v. Crocker National Bank*, 38 Cal.3d 913 (1985) (unconscionability); *Best v. United Bank of Oregon*, 739 P.2d 554, 562—566 (1987) (good faith and fair dealing). In addition, Section 1-203 (A.C.A. § 4-1-203) provides that every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.

4. Section 3-407(c) (A.C.A. § 4-3-407(c)) states that a payor bank or drawee which pays a fraudulently altered instrument in good faith and without notice of the alteration may enforce rights with respect to the instrument according to its original terms or, in the case of an incomplete instrument altered by unauthorized

completion, according to its terms as completed. Section 4-401(d) (A.C.A. § 4-4-401(d)) follows the rule stated in Section 3-407(c) (A.C.A. § 4-3-407(c)) by applying it to an altered item and allows the bank to enforce rights with respect to the altered item by charging the customer's account.

### Comment to § 4-402 (A.C.A. § 4-4-402)

1. Subsection (a) (A.C.A. § 4-4-402(a)) states positively what has been assumed under the original Article: that if a bank fails to honor a properly payable item it may be liable to its customer for wrongful dishonor. Under subsection (b) (A.C.A. § 4-4-402(b)) the payor bank's wrongful dishonor of an item gives rise to a statutory cause of action. Damages may include consequential damages. Confusion has resulted from the attempts of courts to reconcile the first and second sentences of former Section 4-402. The second sentence implied that the bank was liable for some form of damages other than those proximately caused by the dishonor if the dishonor was other than by mistake. But nothing in the section described what these noncompensatory damages might be. Some courts have held that in distinguishing between mistaken dishonors and nonmistaken dishonors, the so-called "trader" rule has been retained that allowed a "merchant or trader" to recover substantial damages for wrongful dishonor without proof of damages actually suffered. Comment 3 to former Section 4-402 indicated that this was not the intent of the drafters. White & Summers, Uniform Commercial Code, Section 18-4 (1988), states: "The negative implication is that when wrongful dishonors occur not 'through mistake' but willfully, the court may impose damages greater than 'actual damages'.... Certainly the reference to 'mistake' in the second sentence of 4-402 invites a court to adopt the relevant pre-Code distinction." Subsection (b) (A.C.A. § 4-4-402(b)) by deleting the reference to mistake in the second sentence precludes any inference that Section 4-402 (A.C.A. § 4-4-402) retains the "trader" rule. Whether a bank is liable for noncompensatory damages, such as punitive damages, must be decided by Section 1-103 and Section 1-106 (A.C.A. § 4-1-103 and § 4-1-106) ("by other rule of law").

2. Wrongful dishonor is different from "failure to exercise ordinary care in handling an item," and the measure of damages is that stated in this section (A.C.A. § 4-4-402), not that stated in Section 4-103(e) (A.C.A. § 4-4-103(e)). By the same token, if a dishonor comes within this section, the measure of damages of this section applies and not another measure of damages. If the wrongful refusal of the beneficiary's bank to make funds available from a funds transfer causes the beneficiary's check to be dishonored, no specific guidance is given as to whether recovery is under this section (A.C.A. § 4-4-402) or Article 4A (A.C.A. § 4-4A-101 et seq.). In each case this issue must be viewed in its factual context, and it was thought unwise to seek to establish certainty at the cost of fairness.

3. The second and third sentences of the subsection (b) (A.C.A. § 4-4-402(b)) reject decisions holding that as a matter of law the dishonor of a check is not the "proximate cause" of the arrest and prosecution of the customer and leave to determination in each case as a question of fact whether the dishonor is or may be the "proximate cause."

4. Banks commonly determine whether there are sufficient funds in an account to pay an item after the close of banking hours on the day of presentment when they post debit and credit items to the account. The determination is made on the basis of credits available for withdrawal as of right or made available for withdrawal by the bank as an accommodation to its customer. When it is determined that payment of the item would overdraw the account, the item may be returned at any time before the bank's midnight deadline the following day. Before the item is returned new credits that are withdrawable as of right may have been added to the account. Subsection (c)



(A.C.A. § 4-4-402(c)) eliminates uncertainty under Article 4 (A.C.A. § 4-4-101 et seq.) as to whether the failure to make a second determination before the item is returned on the day following presentment is a wrongful dishonor if new credits were added to the account on that day that would have covered the amount of the check.

5. Section 4-402 (A.C.A. § 4-4-402) has been construed to preclude an action for wrongful dishonor by a plaintiff other than the bank's customer. *Loucks v. Albuquerque National Bank*, 418 P.2d 191 (N.Mex. 1966). Some courts have allowed a plaintiff other than the customer to sue when the customer is a business entity that is one and the same with the individual or individuals operating it. *Murdaugh Volkswagen, Inc. v. First National Bank*, 801 F.2d 719 (4th Cir. 1986) and *Karsh v. American City Bank*, 113 Cal.App.3d 419, 169 Cal.Rptr. 851 (1980). However, where the wrongful dishonor impugns the repu-

tation of an operator of the business, the issue is not merely, as the court in *Koger v. East First National Bank*, 443 So.2d 141 (Fla.App. 1983), put it, one of a literal versus a liberal interpretation of Section 4-402 (A.C.A. § 4-4-402). Rather the issue is whether the statutory cause of action in Section 4-402 (A.C.A. § 4-4-402) displaces, in accordance with Section 1-103 (A.C.A. § 4-1-103), any cause of action that existed at common law in a person who is not the customer whose reputation was damaged. See *Marcum v. Security Trust and Savings Co.*, 221 Ala. 419, 129 So. 74 (1930). While Section 4-402 (A.C.A. § 4-4-402) should not be interpreted to displace the latter cause of action, the section itself gives no cause of action to other than a "customer," however that definition is construed, and thus confers no cause of action on the holder of a dishonored item. *First American National Bank v. Commerce Union Bank*, 692 S.W.2d 642 (Tenn.App. 1985).

#### Comment to § 4-403 (A.C.A. § 4-4-403)

1. The position taken by this section (A.C.A. § 4-4-403) is that stopping payment or closing an account is a service which depositors expect and are entitled to receive from banks notwithstanding its difficulty, inconvenience and expense. The inevitable occasional losses through failure to stop or close should be borne by the banks as a cost of the business of banking.

2. Subsection (a) (A.C.A. § 4-4-403(a)) follows the decisions holding that a payee or indorsee has no right to stop payment. This is consistent with the provision governing payment or satisfaction. See Section 3-602 (A.C.A. § 4-3-602). The sole exception to this rule is found in Section 4-405 (A.C.A. § 4-4-405) on payment after notice of death, by which any person claiming an interest in the account can stop payment.

3. Payment is commonly stopped only on checks; but the right to stop payment is not limited to checks, and extends to any item payable by any bank. If the maker of a note payable at a bank is in a position analogous to that of a drawer (Section 4-106) (A.C.A. § 4-4-106) the maker may stop payment of the note. By analogy the rule extends to drawees other than banks.

4. A cashier's check or teller's check

purchased by a customer whose account is debited in payment for the check is not a check drawn on the customer's account within the meaning of subsection (a) (A.C.A. § 4-4-403(a)); hence, a customer purchasing a cashier's check or teller's check has no right to stop payment of such a check under subsection (a) (A.C.A. § 4-4-403(a)). If a bank issuing a cashier's check or teller's check refuses to pay the check as an accommodation to its customer or for other reasons, its liability on the check is governed by Section 3-411 (A.C.A. § 4-3-411). There is no right to stop payment after certification of a check or other acceptance of a draft, and this is true no matter who procures the certification. See Sections 3-411 and 4-303 (A.C.A. §§ 4-3-411 and 4-4-303). The acceptance is the drawee's own engagement to pay, and it is not required to impair its credit by refusing payment for the convenience of the drawer.

5. Subsection (a) (A.C.A. § 4-4-403(a)) makes clear that if there is more than one person authorized to draw on a customer's account any one of them can stop payment of any check drawn on the account or can order the account closed. Moreover, if there is a customer, such as a corporation,

that requires its checks to bear the signatures of more than one person, any of these persons may stop payment on a check. In describing the item, the customer, in the absence of a contrary agreement, must meet the standard of what information allows the bank under the technology then existing to identify the item with reasonable certainty.

6. Under subsection (b) (A.C.A. § 4-4-403(b)), a stop-payment order is effective after the order, whether written or oral, is received by the bank and the bank has a reasonable opportunity to act on it. If the order is written it remains in effect for six months from that time. If the order is oral it lapses after 14 days unless there is written confirmation. If there is written confirmation with the 14-day period, the six-month period dates from the giving of the oral order. A stop-payment order may be renewed any number of times by written notice given during a six-month period while a stop order is in effect. A new stop-payment order may be given after a six-month period expires, but such a notice takes effect from the date given. When a stop-payment order expires it is as though the order had never been given, and the payor bank may pay the item in good faith under Section 4-404 (A.C.A. § 4-4-404) even though a stop-payment order had once been given.

7. A payment in violation of an effective direction to stop payment is an improper payment, even though it is made by mistake or inadvertence. Any agreement to the contrary is invalid under Section 4-103(a) (A.C.A. § 4-4-103(a)) if in paying

the item over the stop-payment order the bank has failed to exercise ordinary care. An agreement to the contrary which is imposed upon a customer as part of a standard form contract would have to be evaluated in the light of the general obligation of good faith. Sections 1-203 and 4-104(c) (A.C.A. §§ 4-1-203 and 4-4-104(c)). The drawee is, however, entitled to subrogation to prevent unjust enrichment (Section 4-407) (A.C.A. § 4-4-407); retains common law defenses, e.g., that by conduct in recognizing the payment the customer has ratified the bank's action in paying over a stop-payment order (Section 1-103) (A.C.A. § 4-1-103); and retains common law rights, e.g., to recover money paid under a mistake under Section 3-418 (A.C.A. § 4-3-418). It has sometimes been said that payment cannot be stopped against a holder in due course, but the statement is inaccurate. The payment can be stopped but the drawer remains liable on the instrument to the holder in due course (Sections 3-305, 3-414) (A.C.A. §§ 4-3-305 and 4-3-414) and the drawee, if it pays, becomes subrogated to the rights of the holder in due course against the drawer. Section 4-407 (A.C.A. § 4-4-407). The relationship between Sections 4-403 and 4-407 (A.C.A. §§ 4-4-403 and 4-4-407) is discussed in the comments to Section 4-407 (A.C.A. § 4-4-407). Any defenses available against a holder in due course remain available to the drawer, but other defenses are cut off to the same extent as if the holder were bringing the action.

#### **Comment to § 4-404 (A.C.A. § 4-4-404)**

This section (A.C.A. § 4-4-404) incorporates a type of statute that has been adopted in 26 jurisdictions before the Code (A.C.A. § 4-1-101 et seq.). The time limit is set at six months because banking and commercial practice regards a check outstanding for longer than that period as stale, and a bank will normally not pay such a check without consulting the depositor. It is therefore not required to do so, but is given the option to pay because it

may be in a position to know, as in the case of dividend checks, that the drawer wants payment made.

Certified checks are excluded from the section because they are the primary obligation of the certifying bank (Sections 3-409 and 3-413) (A.C.A. §§ 4-3-409 and 4-3-413). The obligation runs directly to the holder of the check. The customer's account was presumably charged when the check was certified.



**Comment to § 4-405 (A.C.A. § 4-4-405)**

1. Subsection (a) (A.C.A. § 4-4-405(a)) follows existing decisions holding that a drawee (payor) bank is not liable for the payment of a check before it has notice of the death or incompetence of the drawer. The justice and necessity of the rule are obvious. A check is an order to pay which the bank must obey under penalty of possible liability for dishonor. Further, with the tremendous volume of items handled any rule that required banks to verify the continued life and competency of drawers would be completely unworkable.

One or both of these same reasons apply to other phases of the bank collection and payment process and the rule is made wide enough to apply to these other phases. It applies to all kinds of "items"; to "customers" who own items as well as "customers" who draw or make them; to the function of collecting items as well as the function of accepting or paying them; to the carrying out of instructions to account for proceeds even though these may involve transfers to third parties; to depository and intermediary banks as well as payor banks; and to incompetency existing at the time of the issuance of an item or the commencement of the collection or payment process as well as to incompetency occurring thereafter. Further, the requirement of actual knowledge makes inapplicable the rule of some cases that an adjudication of incompetency is constructive notice to all the world because obviously it is as impossible for banks to keep posted on such adjudications (in the absence of actual knowledge) as it is to keep posted as to death of immediate or remote customers.

2. Subsection (b) (A.C.A. § 4-4-405(b)) provides a limited period after death during which a bank may continue to pay checks (as distinguished from other items) even though it has notice. The purpose of the provision, as of the existing statutes, is to permit holders of checks drawn and issued shortly before death to cash them without the necessity of filing a claim in probate. The justification is that these checks normally are given in immediate payment of an obligation, that there is almost never any reason why they should not be paid, and that filing in probate is a useless formality, burdensome to the holder, the executor, the court and the bank.

This section (A.C.A. § 4-4-405) does not prevent an executor or administrator from recovering the payment from the holder of the check. It (A.C.A. § 4-4-405) is not intended to affect the validity of any gift causa mortis or other transfer in contemplation of death, but merely to relieve the bank of liability for the payment.

3. Any surviving relative, creditor or other person who claims an interest in the account may give a direction to the bank not to pay checks, or not to pay a particular check. Such notice has the same effect as a direction to stop payment. The bank has no responsibility to determine the validity of the claim or even whether it is "colorable." But obviously anyone who has an interest in the estate, including the person named as executor in a will, even if the will has not yet been admitted to probate, is entitled to claim an interest in the account.

**Comment to § 4-406 (A.C.A. § 4-4-406)**

1. In order to impose on its customer the duty stated in subsection (c) (A.C.A. § 4-4-406(c)) to examine a statement or the returned items and report unauthorized signatures of the customer or alterations, the bank must comply with subsection (a) (A.C.A. § 4-4-406(a)) in sending or making available to the customer a statement of account. Whether the bank returns to the customer the item paid is a matter for bank-customer agreement. If the agreement is that the bank does not

return the items paid, a general standard is stated that the customer must be given information "sufficient to allow the customer reasonably to identify the items paid." If the bank supplies its customer with an image of an item, it complies with this standard. But a safe harbor rule is provided. If the item is described by item number, amount, and date of payment, the bank does comply. This information was chosen because it can be obtained by the bank's computer from the check's

MICR line without examination of the items involved. The other two items of information that the customer would normally want to know—the name of the payee and the date of the item—cannot currently be obtained from the MICR line. The safe harbor rule is important in determining the feasibility of payor or collecting bank check retention plans. A customer who keeps a record of items written will have sufficient information to identify the item on the basis of item number, amount and date of payment. But customers who don't keep records may not. The policy decision is that accommodating these customers is not as desirable as accommodating others who keep more careful records at less cost to the check collection system and, thus, to all customers of the system. It is expected that technological advances may make it possible for banks to give customers more information in the future in a manner that is fully compatible with automation or truncation systems. At that time the Permanent Editorial Board may wish to make recommendations for an amendment revising the safe harbor requirements in the light of these advances.

2. Subsection (b) (A.C.A. § 4-4-406(b)) applies if the items are not returned to the customer. Check retention plans may include a simple payor bank check retention plan or the kind of check retention plan that would be authorized by a truncation agreement in which a collecting bank or the payee may retain the items. Even after agreeing to a check retention plan, a customer may need to see one or more checks for litigation or other purposes. The customer's request for the check may always be made to the payor bank. Under subsection (b) (A.C.A. § 4-4-406(b)) retaining banks may destroy items but must maintain the capacity to furnish legible copies for seven years. A legible copy may include an image of an item. This Act (A.C.A. § 4-4-101 et seq.) does not define the length of the reasonable period of time for a bank to provide the check or copy of the check. What is reasonable depends on the capacity of the bank and the needs of the customer. This Act (A.C.A. § 4-4-101 et seq.) does not specify sanctions for failure to retain or furnish the items or legible copies; this is left to other laws regulating banks. See Comment 3 to Section 4-101 (A.C.A. § 4-4-101). Moreover,

this Act (A.C.A. § 4-4-101 et seq.) does not regulate fees that banks charge their customers for furnishing items or copies or other services covered by the Act (A.C.A. § 4-4-101 et seq.), but under principles of law such as unconscionability or good faith and fair dealing, courts have reviewed fees and the bank's exercise of a discretion to set fees. *Perdue v. Crocker National Bank*, 38 Cal.3d 913 (1985) (unconscionability); *Best v. United Bank of Oregon*, 739 P.2d 554, 562—566 (1987) (good faith and fair dealing). In addition, Section 1-203 (A.C.A. § 4-1-203) provides that every contract or duty within this Act (A.C.A. § 4-4-101 et seq.) imposes an obligation of good faith in its performance or enforcement.

3. Subsection (c) (A.C.A. § 4-4-406(c)) imposes on the customer the duty to examine for and report unauthorized payments. Subsection (d)(2) (A.C.A. § 4-4-406(d)(2)) changes former subsection (2)(b) by adopting a 30-day period in place of a 14-day period. Although the 14-day period may have been sufficient when the original version of Article 4 was drafted in the 1950s, given the much greater volume of checks at the time of the revision, a longer period was viewed as more appropriate. The rule of subsection (d)(2) (A.C.A. § 4-4-406(d)(2)) follows pre-Code case law that payment of an additional item or items bearing an unauthorized signature or alteration by the same wrongdoer is a loss suffered by the bank traceable to the customer's failure to exercise reasonable care in examining the statement and notifying the bank of objections to it. One of the most serious consequences of failure of the customer to comply with the requirements of subsection (c) (A.C.A. § 4-4-406(c)) is the opportunity presented to the wrongdoer to repeat the misdeeds. Conversely, one of the best ways to keep down losses in this type of situation is for the customer to promptly examine the statement and notify the bank of an unauthorized signature or alteration so that the bank will be alerted to stop paying further items. Hence, the rule of subsection (d)(2) (A.C.A. § 4-4-406(d)(2)) is prescribed, and to avoid dispute a specific time limit, 30 days, is designated for cases to which the subsection applies. These considerations are not present if there are no losses resulting from the payment of additional items. In



these circumstances, a reasonable period for the customer to comply with its duties under subsection (c) (A.C.A. § 4-4-406(c)) would depend on the circumstances (Sections 1-204(2)) (A.C.A. § 4-1-204(2)) and the subsection (d)(2) (A.C.A. § 4-4-406(d)(2)) time limit should not be imported by analogy into subsection (c) (A.C.A. § 4-4-406(c)).

4. Subsection (e) (A.C.A. § 4-4-406(e)) replaces former subsection (3) and poses a modified comparative negligence test for determining liability. See the discussion on this point in the Comments to Sections 3-404, 3-405 and 3-406 (A.C.A. §§ 4-3-404, 4-3-405, and 4-3-406). The term “good faith” is defined in Section 3-103(a)(4) (A.C.A. § 4-3-103(a)(4)) as including “observance of reasonable commercial standards of fair dealing.” The connotation of this standard is fairness and not absence of negligence.

The term “ordinary care” used in subsection (e) (A.C.A. § 4-4-406(e)) is defined in Section 3-103(a)(7) (A.C.A. § 4-3-103(a)(7)), made applicable to Article 4 (A.C.A. § 4-4-101 et seq.) by Section 4-104(c) (A.C.A. § 4-4-104(c)), to provide that sight examination by a payor bank is not required if its procedure is reasonable and is commonly followed by other comparable banks in the area. The case law is divided on this issue. The definition of “ordinary care” in Section 3-103 (A.C.A. § 4-3-103) rejects those authorities that hold, in effect, that failure to use sight examination is negligence as a matter of law. The effect of the definition of “ordinary care” on Section 4-406 (A.C.A. § 4-4-406) is only to provide that in the small

percentage of cases in which a customer’s failure to examine its statement or returned items has led to loss under subsection (d) (A.C.A. § 4-4-406(d)) a bank should not have to share that loss solely because it has adopted an automated collection or payment procedure in order to deal with the great volume of items at a lower cost to all customers.

5. Several changes are made in former Section 4-406(5). First, former subsection (5) is deleted and its substance is made applicable only to the one-year notice preclusion in former subsection (4) (subsection (f)) (A.C.A. § 4-4-406(f)). Thus if a drawer has not notified the payor bank of an unauthorized check or material alteration within the one-year period, the payor bank may not choose to recredit the drawer’s account and pass the loss to the collecting banks on the theory of breach of warranty. Second, the reference in former subsection (4) to unauthorized indorsements is deleted. Section 4-406 (A.C.A. § 4-4-406) imposes no duties on the drawer to look for unauthorized indorsements. Section 4-111 (A.C.A. § 4-4-111) sets out a statute of limitations allowing a customer a three-year period to seek a credit to an account improperly charged by payment of an item bearing an unauthorized indorsement. Third, subsection (c) is added to Section 4-208 (A.C.A. § 4-4-208(c)) to assure that if a depository bank is sued for breach of a presentment warranty, it can defend by showing that the drawer is precluded by Section 3-406 (A.C.A. § 4-3-406) or Section 4-406(c) and (d) (A.C.A. § 4-4-406(c) and (d)).

### Revised Official Comment

1. Under subsection (a) (A.C.A. § 4-4-406(a)), if a bank that has paid a check or other item for the account of a customer makes available to the customer a statement of account showing payment of the item, the bank must either return the item to the customer or provide a description of the item sufficient to allow the customer to identify it. Under subsection (c), the customer has a duty to exercise reasonable promptness in examining the statement or the returned item to discover any unauthorized signature of the customer or any alteration and to promptly notify the bank if the customer should

reasonably have discovered the unauthorized signature or alteration.

The duty stated in subsection (c) (A.C.A. § 4-4-406(c)) becomes operative only if the “bank sends or makes available a statement of account or items pursuant to subsection (a) (A.C.A. § 4-4-406(a)).” A bank is not under a duty to send a statement of account or the paid items to the customer; but, if it does not do so, the customer does not have any duties under subsection (c) (A.C.A. § 4-4-406(c)).

Under subsection (a) (A.C.A. § 4-4-406(a)), a statement of account must provide information “sufficient to allow the

customer reasonably to identify the items paid.” If the bank supplies its customer with an image of the paid item, it complies with this standard. But a safe harbor rule is provided. The bank complies with the standard of providing “sufficient information” if “the item is described by item number, amount, and date of payment.” This means that the customer’s duties under subsection (c) (A.C.A. § 4-4-406(c)) are triggered if the bank sends a statement of account complying with the safe harbor rule without returning the paid items. A bank does not have to return the paid items unless it has agreed with the customer to do so. Whether there is such an agreement depends upon the particular circumstances. See Section 1-201(3) (A.C.A. § 4-1-201(3)). If the bank elects to provide the minimum information that is “sufficient” under subsection (a) (A.C.A. § 4-4-406(a)) and, as a consequence, the customer could not “reasonably have discovered the unauthorized payment,” there is no preclusion under subsection (d) (A.C.A. § 4-4-406(d)). If the customer made a record of the issued checks on the check stub or carbonized copies furnished by the bank in the checkbook, the customer should usually be able to verify the paid items shown on the statement of account and discover any unauthorized or altered checks. But there could be exceptional circumstances. For example, if a check is altered by changing the name of the payee, the customer could not normally detect the fraud unless the customer is given the paid check or the statement of account discloses the name of the payee of the altered check. If the customer could not “reasonably have discovered the unauthorized payment” under subsection (c) (A.C.A. § 4-4-406(c)) there would not be a preclusion under subsection (d) (A.C.A. § 4-4-406(d)).

The “safe harbor” provided by subsection (a) (A.C.A. § 4-4-406(a)) serves to permit a bank, based on the state of existing technology, to trigger the customer’s duties under subsection (c) (A.C.A. § 4-4-406(c)) by providing a “statement of account showing payment of items” without having to return the paid items, in any case in which the bank has not agreed with the customer to return the paid items. The “safe harbor” does not, however, preclude a customer under subsection (d) (A.C.A. § 4-4-406(d)) from assert-

ing its unauthorized signature or an alteration against a bank in those circumstances in which under subsection (c) (A.C.A. § 4-4-406(c)) the customer should not “reasonably have discovered the unauthorized payment.” Whether the customer has failed to comply with its duties under subsection (c) (A.C.A. § 4-4-406(c)) is determined on a case-by-case basis.

The provision in subsection (a) (A.C.A. § 4-4-406(a)) that a statement of account contains “sufficient information if the item is described by item number, amount, and date of payment” is based upon the existing state of technology. This information was chosen because it can be obtained by the bank’s computer from the check’s MICR line without examination of the items involved. The other two items of information that the customer would normally want to know — the name of the payee and the date of the item — cannot currently be obtained from the MICR line. The safe harbor rule is important in determining the feasibility of payor or collecting bank check retention plans. A customer who keeps a record of checks written, e.g., on the check stubs or carbonized copies of the checks supplied by the bank in the checkbook, will usually have sufficient information to identify the items on the basis of item number, amount, and date of payment. But customers who do not utilize these record-keeping methods may not. The policy decision is that accommodating customers who do not keep adequate records is not as desirable as accommodating customers who keep more careful records. This policy results in less cost to the check collection system and thus to all customers of the system. It is expected that technological advances such as image processing may make it possible for banks to give customers more information in the future in a manner that is fully compatible with automation or truncation systems. At that time the Permanent Editorial Board may wish to make recommendations for an amendment revising the safe harbor requirements in the light of those advances.

2. Subsection (d) (A.C.A. § 4-4-406(d)) states the consequences of a failure by the customer to perform its duty under subsection (c) (A.C.A. § 4-4-406(c)) to report an alteration or the customer’s unauthorized signature. Subsection (d)(1) (A.C.A. § 4-4-406(d)(1)) applies to the unautho-



rized payment of the item to which the duty to report under subsection (c) (A.C.A. § 4-4-406(c)) applies. If the bank proves that the customer "should reasonably have discovered the unauthorized payment" (See Comment 1) and did not notify the bank, the customer is precluded from asserting against the bank the alteration or the customer's unauthorized signature if the bank proves that it suffered a loss as a result of the failure of the customer to perform its subsection (c) (A.C.A. § 4-4-406(c)) duty. Subsection (d)(2) (A.C.A. § 4-4-406(d)(2)) applies to cases in which the customer fails to report an unauthorized signature or alteration with respect to an item in breach of the subsection (c) (A.C.A. § 4-4-406(c)) duty (See Comment 1) and the bank subsequently pays other items of the customer with respect to which there is an alteration or unauthorized signature of the customer and the same wrongdoer is involved. If the payment of the subsequent items occurred after the customer has had a reasonable time (not exceeding 30 days) to report with respect to the first item and before the bank received notice of the unauthorized signature or alteration of the first item, the customer is precluded from asserting the alteration or unauthorized signature with respect to the subsequent items.

If the customer is precluded in a single or multiple item unauthorized payment situation under subsection (d) (A.C.A. § 4-4-406(d)), but the customer proves that the bank failed to exercise ordinary care in paying the item or items and that the failure substantially contributed to the loss, subsection (e) (A.C.A. § 4-4-406(e)) provides a comparative negligence test for allocating loss between the customer and the bank. Subsection (e) (A.C.A. § 4-4-406(e)) also states that, if the customer proves that the bank did not pay the item in good faith, the preclusion under subsection (d) (A.C.A. § 4-4-406(d)) does not apply.

Subsection (d)(2) (A.C.A. § 4-4-406(d)(2)) changes former subsection (2)(b) by adopting a 30-day period in place of a 14-day period. Although the 14-day period may have been sufficient when the original version of Article 4 (A.C.A. § 4-4-101 et seq.) was drafted in the 1950s, given the much greater volume of checks at the time of the revision, a longer period was viewed as more appropriate. The rule

of subsection (d)(2) (A.C.A. § 4-4-406(d)(2)) follows pre-Code case law that payment of an additional item or items bearing an unauthorized signature or alteration by the same wrongdoer is a loss suffered by the bank traceable to the customer's failure to exercise reasonable care (See Comment 1) in examining the statement and notifying the bank of objections to it. One of the most serious consequences of failure of the customer to comply with the requirements of subsection (c) (A.C.A. § 4-4-406(c)) is the opportunity presented to the wrongdoer to repeat the misdeeds. Conversely, one of the best ways to keep down losses in this type of situation is for the customer to promptly examine the statement and notify the bank of an unauthorized signature or alteration so that the bank will be alerted to stop paying further items. Hence, the rule of subsection (d)(2) (A.C.A. § 4-4-406(d)(2)) is prescribed, and to avoid dispute a specific time limit, 30 days, is designated for cases to which the subsection applies. These considerations are not present if there are no losses resulting from the payment of additional items. In these circumstances, a reasonable period for the customer to comply with its duties under subsection (c) (A.C.A. § 4-4-406(c)) would depend on the circumstances (Section 1-204(2)) (A.C.A. § 4-1-204(2)) and the subsection (d)(2) (A.C.A. § 4-4-406(d)(2)) time limit should not be imported by analogy into subsection (c) (A.C.A. § 4-4-406(c)).

3. Subsection (b) (A.C.A. § 4-4-406(b)) applies if the items are not returned to the customer. Check retention plans may include a simple payor bank check retention plan or the kind of check retention plan that would be authorized by a truncation agreement in which a collecting bank or the payee may retain the items. Even after agreeing to a check retention plan, a customer may need to see one or more checks for litigation or other purposes. The customer's request for the check may always be made to the payor bank. Under subsection (b) (A.C.A. § 4-4-406(b)) retaining banks may destroy items but must maintain the capacity to furnish legible copies for seven years. A legible copy may include an image of an item. This Act does not define the length of the reasonable period of time for a bank to provide the check or copy of the check. What is rea-

sonable depends on the capacity of the bank and the needs of the customer. This Act (A.C.A. § 4-4-101 et seq.) does not specify sanctions for failure to retain or furnish the items or legible copies; this is left to other laws regulating banks. See Comment 3 to Section 4-101 (A.C.A. § 4-4-101). Moreover, this Act (A.C.A. § 4-1-101 et seq.) does not regulate fees that banks charge their customers for furnishing items or copies or other services covered by the Act (A.C.A. § 4-1-101 et seq.), but under principles of law such as unconscionability or good faith and fair dealing, courts have reviewed fees and the bank's exercise of a discretion to set fees. *Perdue v. Crocker National Bank*, 38 Cal.3d 913 (1985) (unconscionability); *Best v. United Bank of Oregon*, 739 P.2d 554, 562-566 (1987) (good faith and fair dealing). In addition, Section 1-203 (A.C.A. § 4-1-203) provides that every contract or duty within this Act (A.C.A. § 4-1-101 et seq.) imposes an obligation of good faith in its performance or enforcement.

4. Subsection (e) (A.C.A. § 4-4-406(e)) replaces former subsection (3) and poses a modified comparative negligence test for determining liability. See the discussion on this point in the Comments to Sections 3-404, 3-405, and 3-406 (A.C.A. §§ 4-3-404, 4-3-405, and 4-3-406). The term "good faith" is defined in Section 3-103(a)(4) (A.C.A. § 4-3-103(a)(4)) as including "observance of reasonable commercial standards of fair dealing." The connotation of this standard is fairness and not absence of negligence.

The term "ordinary care" used in subsection (e) (A.C.A. § 4-4-406(e)) is defined in Section 3-103(a)(7) (A.C.A. § 4-3-103(a)(7)), made applicable to Article 4 (A.C.A. § 4-1-101 et seq.) by Section 4-104(c) (A.C.A. § 4-4-104(c)), to provide that sight examination by a payor bank is not required if its procedure is reasonable and is commonly followed by other comparable banks in the area. The case law is divided on this issue. The definition of

"ordinary care" in Section 3-103 (A.C.A. § 4-3-103) rejects those authorities that hold, in effect, that failure to use sight examination is negligence as a matter of law. The effect of the definition of "ordinary care" on Section 4-406 (A.C.A. § 4-4-406) is only to provide that in the small percentage of cases in which a customer's failure to examine its statement or returned items has led to loss under subsection (d) (A.C.A. § 4-4-406(d)) a bank should not have to share that loss solely because it has adopted an automated collection or payment procedure in order to deal with the great volume of items at a lower cost to all customers.

5. Several changes are made in former Section 4-406(5). First, former subsection (5) is deleted and its substance is made applicable only to the one-year notice preclusion in former subsection (4) subsection (f) (A.C.A. § 4-4-406(f)). Thus if a drawer has not notified the payor bank of an unauthorized check or material alteration within the one-year period, the payor bank may not choose to recredit the drawer's account and pass the loss to the collecting banks on the theory of breach of warranty. Second, the reference in former subsection (4) to unauthorized indorsements is deleted. Section 4-406 (A.C.A. § 4-4-406) imposes no duties on the drawer to look for unauthorized indorsements. Section 4-111 (A.C.A. § 4-4-111) sets out a statute of limitations allowing a customer a three-year period to seek a credit to an account improperly charged by payment of an item bearing an unauthorized indorsement. Third, subsection (c) is added to Section 4-208 (A.C.A. § 4-4-208(c)) to assure that if a depository bank is sued for breach of a presentment warranty, it can defend by showing that the drawer is precluded by Section 3-406 (A.C.A. § 4-3-406) or Section 4-406(c) and (d) (A.C.A. § 4-4-406(c) and (d)). *Revisions approved by the Permanent Editorial Board for the Uniform Commercial Code March 16, 1991.*

#### Comment to § 4-407 (A.C.A. § 4-4-407)

1. Section 4-403 (A.C.A. § 4-4-403) states that a stop-payment order or an order to close an account is binding on a bank. If a bank pays an item over such an order it is prima facie liable, but under

subsection (c) of Section 4-403 (A.C.A. § 4-4-403(c)) the burden of establishing the fact and amount of loss from such payment is on the customer. A defense frequently interposed by a bank in an



action against it for wrongful payment over a stop-payment order is that the drawer or maker suffered no loss because it would have been liable to a holder in due course in any event. On this argument some cases have held that payment cannot be stopped against a holder in due course. Payment can be stopped, but if it is, the drawer or maker is liable and the sound rule is that the bank is subrogated to the rights of the holder in due course. The preamble and paragraph (1) (A.C.A. § 4-4-407(1)) of this section state this rule.

2. Paragraph (2) (A.C.A. § 4-4-407(2)) also subrogates the bank to the rights of the payee or other holder against the drawer or maker either on the item or under the transaction out of which it arose. It may well be that the payee is not a holder in due course but still has good rights against the drawer. These may be on the check but also may not be as, for example, where the drawer buys goods from the payee and the goods are partially defective so that the payee is not entitled to the full price, but the goods are still worth a portion of the contract price. If the drawer retains the goods it is obligated to pay a part of the agreed price. If the bank has paid the check it should be subrogated to this claim of the payee against the drawer.

3. Paragraph (3) (A.C.A. § 4-4-407(3)) subrogates the bank to the rights of the drawer or maker against the payee or

other holder with respect to the transaction out of which the item arose. If, for example, the payee was a fraudulent salesman inducing the drawer to issue a check for defective securities, and the bank pays the check over a stop-payment order but reimburses the drawer for such payment, the bank should have a basis for getting the money back from the fraudulent salesman.

4. The limitations of the preamble prevent the bank itself from getting any double recovery or benefits out of its subrogation rights conferred by the section.

5. The spelling out of the affirmative rights of the bank in this section (A.C.A. § 4-4-407) does not destroy other existing rights (Section 1-103) (A.C.A. § 4-1-103). Among others these may include the defense of a payor bank that by conduct in recognizing the payment a customer has ratified the bank's action in paying in disregard of a stop-payment order or right to recover money paid under a mistake.

#### *Cross References:*

Section 4-403 (A.C.A. § 4-4-403).

#### *Definitional Cross References:*

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Holder in due course". Section 3-302 (A.C.A. § 4-3-302).

"Item". Section 4-104 (A.C.A. § 4-4-104).

"Payor bank". Section 4-105 (A.C.A. § 4-4-105).

### **Comment to § 4-501 (A.C.A. § 4-4-501)**

This section (A.C.A. § 4-4-501) states the duty of a bank handling a documentary draft for a customer. "Documentary draft" is defined in Section 4-104 (A.C.A. § 4-4-104). The duty stated exists even if the bank has bought the draft. This is

because to the customer the draft normally represents an underlying commercial transaction, and if that is not going through as planned the customer should know it promptly.

### **Comment to § 4-502 (A.C.A. § 4-4-502)**

The section (A.C.A. § 4-4-502) is designed to establish a definite rule for "on arrival" drafts. The term includes not only drafts drawn payable "on arrival" but also drafts forwarded with instructions to present "on arrival." The term refers to the arrival of the relevant goods. Unless a bank has actual knowledge of the arrival of the goods, as for example, when it is the

"notify" party on the bill of lading, the section (A.C.A. § 4-4-502) only requires the exercise of such judgment in estimating time as a bank may be expected to have. Commonly the buyer-drawee will want the goods and will therefore call for the documents and take up the draft when they do arrive.

**Comment to § 4-503 (A.C.A. § 4-4-503)**

1. This section (A.C.A. § 4-4-503) states the rules governing, in the absence of instructions, the duty of the presenting bank in case either of honor or of dishonor of a documentary draft. The section (A.C.A. § 4-4-503) should be read in connection with Section 2-514 (A.C.A. § 4-2-

514) on when documents are deliverable on acceptance, when on payment.

2. If the draft is drawn under a letter of credit, Article 5 (A.C.A. § 4-5-101 et seq.) controls. See Sections 5-109 through 5-114 (A.C.A. §§ 4-5-109—4-5-114).

**Comment to § 4-504 (A.C.A. § 4-4-504)**

The section (A.C.A. § 4-4-504) gives the presenting bank, after dishonor, a privilege to deal with the goods in any commercially reasonable manner pending instructions from its transferor and, if still unable to communicate with its principal after a reasonable time, a right to realize its expenditures as if foreclosing on an unpaid seller's lien (Section 2-706) (A.C.A. § 4-2-706). The provision includes situa-

tions in which storage of goods or other action becomes commercially necessary pending receipt of any requested instructions, even if the requested instructions are later received.

The "reasonable manner" referred to means one reasonable in the light of business factors and the judgment of a business man.



**ARTICLE 4A**  
**(A.C.A. § 4-4A-101 ET SEQ.)\***

\*Article 4A (A.C.A. § 4-4A-101 et seq.) with conforming amendments was enacted by Acts 1991, No. 540.

**Prefatory Note**

The National Conference of Commissioners on Uniform State laws and The American Law Institute have approved a new Article 4A (A.C.A. § 4-4A-101 et seq.) to the Uniform Commercial Code. Comments that follow each of the sections of the statute are intended as official comments. They explain in detail the purpose and meaning of the various sections and the policy considerations on which they are based.

*Description of transaction covered by Article 4A (A.C.A. § 4-4A-101 et seq.).*

There are a number of mechanisms for making payments through the banking system. Most of these mechanisms are covered in whole or part by state or federal statutes. In terms of number of transactions, payments made by check or credit card are the most common payment methods. Payment by check is covered by Article 3 and 4 (A.C.A. § 4-3-101 et seq. and § 4-4-101 et seq.) of the UCC and some aspects of payment by credit card are covered by federal law. In recent years electronic funds transfers have been increasingly common in consumer transactions. For example, in some cases a retail customer can pay for purchases by use of an access or debit card inserted in a terminal at the retail store that allows the bank account of the customer to be instantly debited. Some aspects of these point-of-sale transactions and other consumer payments that are effected electronically are covered by a federal statute, the Electronic Fund Transfer Act (EFTA). If any part of a funds transfer is covered by EFTA, the entire funds transfer is excluded from Article 4A (A.C.A. § 4-4A-101 et seq.).

Another type of payment, commonly referred to as a wholesale wire transfer, is the primary focus of Article 4A (A.C.A. § 4-4A-101 et seq.). Payments that are covered by Article 4A (A.C.A. § 4-4A-101 et seq.) are overwhelmingly between business or financial institutions. The dollar volume of payments made by wire trans-

fer far exceeds the dollar volume of payments made by other means. The volume of payments by wire transfer over the two principal wire payment systems—the Federal Reserve wire transfer network (Fedwire) and the New York Clearing House Interbank Payments Systems (CHIPS)—exceeds one trillion dollars per day. Most payments carried out by use of automated clearing houses are consumer payments covered by EFTA and therefore not covered by Article 4A (A.C.A. § 4-4A-101 et seq.). There is, however, a significant volume of nonconsumer ACH payments that closely resemble wholesale wire transfers. These payments are also covered by Article 4A (A.C.A. § 4-4A-101 et seq.).

There is some resemblance between payments made by other means such as paper-based checks and credit cards or electronically-based consumer payments, but there are also many differences. Article 4A (A.C.A. § 4-4A-101 et seq.) excludes from its coverage these other payment mechanisms. Article 4A (A.C.A. § 4-4A-101 et seq.) follows a policy of treating the transaction that it covers—a “funds transfer”—as a unique method of payment that is governed by unique principles of law that address the operational and policy issues presented by this kind of payment.

The funds transfer that is covered by Article 4A (A.C.A. § 4-4A-101 et seq.) is not a complex transaction and can be illustrated by the following example which used throughout the Prefatory Note as a basis for discussion. X, a debtor, wants to pay an obligation owed to Y. Instead of delivering to Y a negotiable instrument such as a check or some other writing such as a credit card slip that enables Y to obtain payment from a bank, X transmits an instruction to X's bank to credit a sum of money to the bank account of Y. In most cases X's bank and Y's bank are different banks. X's bank may carry out X's instruction by instructing Y's bank to credit Y's account in the amount that X

requested. The instruction that X issues to its bank is a "payment order." X is the "sender" of the payment order and X's bank is the "receiving bank" with respect to X's order. Y is the "beneficiary" of X's order. When X's bank issues an instruction to Y's bank to carry out X's payment order, X's bank "executes" X's order. The instruction of X's bank to Y's bank is also a payment order. With respect to that order, X's bank is the sender, Y's bank is the receiving bank, and Y is the beneficiary. The entire series of transactions by which X pays Y is known as the "funds transfer." With respect to the funds transfer, X is the "originator," X's bank is the "originator bank," Y is the "beneficiary" and Y's bank is the "beneficiary's bank." In more complex transactions there are one or more additional banks known as "intermediary banks" between X's bank and Y's bank. In the funds transfer the instruction contained in the payment order of X to its bank is carried out by a series of payment orders by each bank in the transmission chain to the next bank in the chain until Y's bank receives a payment order to make the credit to Y's account. In most cases, the payment order of each bank to the next bank in the chain is transmitted electronically, and often the payment order of X to its bank is also transmitted electronically, but the means of transmission does not have any legal significance. A payment order may be transmitted by any means, and in some cases the payment order is transmitted by a slow means such as first class mail. To reflect this fact, the broader term "funds transfer" rather than the narrower term "wire transfer" is used in Article 4A (A.C.A. § 4-4A-101 et seq.) to describe the overall payment transaction.

Funds transfers are divided into two categories determined by whether the instruction to pay is given by the person making payment or the person receiving payment. If the instruction is given by the person making the payment, the transfer is commonly referred to as a "credit transfer." If the instruction is given by the person receiving payment, the transfer is commonly referred to as a "debit transfer." Article 4A (A.C.A. § 4-4A-101 et seq.) governs credit transfers and excludes debit transfers.

*Why is Article 4A (A.C.A. § 4-4A-101 et seq.) needed?*

There is no comprehensive body of law that defines the rights and obligations that arise from wire transfers. Some aspects of wire transfers are governed by rules of the principal transfer systems. Transfers made by Fedwire are governed by Federal Reserve Regulation J and transfers over CHIPS are governed by the CHIPS rules. Transfers made by means of automated clearing houses are governed by uniform rules adopted by various associations of banks in various parts of the nation or by Federal Reserve rules or operating circulars. But the various funds transfer system rules apply to only limited aspects of wire transfer transactions. The resolution of the many issues that are not covered by funds transfer system rules depends on contracts of the parties, to the extent that they exist, or principles of law applicable to other payment mechanisms that might be applied by analogy. The result is a great deal of uncertainty. There is no consensus about the juridical nature of a wire transfer and consequently of the rights and obligations that are created. Article 4A (A.C.A. § 4-4A-101 et seq.) is intended to provide the comprehensive body of law that we do not have today.

#### *Characteristics of a funds transfer.*

There are a number of characteristics of funds transfers covered by Article 4A (A.C.A. § 4-4A-101 et seq.) that have influenced the drafting of the statute. The typical funds transfer involves a large amount of money. Multimillion dollar transactions are commonplace. The originator of the transfer and the beneficiary are typically sophisticated business or financial organizations. High speed is another predominant characteristic. Most funds transfers are completed on the same day, even in complex transactions in which there are several intermediary banks in the transmission chain. A funds transfer is a highly efficient substitute for payments made by the delivery of paper instruments. Another characteristic is extremely low cost. A transfer that involves many millions of dollars can be made for a price of a few dollars. Price does not normally vary very much or at all with the amount of the transfer. This system of pricing may not be feasible if the bank is exposed to very large liabilities in connection with the transaction. The pricing system assumes that the price reflects prima-



rily the cost of the mechanical operation performed by the bank, but in fact, a bank may have more or less potential liability with respect to a funds transfer depending upon the amount of the transfer. Risk of loss to banks carrying out a funds transfer may arise from a variety of causes. In some funds transfers, there may be extensions of very large amounts of credit for short periods of time by the banks that carry out a funds transfer. If a payment order is issued to the beneficiary's bank, it is normal for the bank to release funds to the beneficiary immediately. Sometimes, payment to the beneficiary's bank by the bank that issued the order to the beneficiary's bank is delayed until the end of the day. If that payment is not received because of the insolvency of the bank that is obliged to pay, the beneficiary's bank may suffer a loss. There is also risk of loss if a bank fails to execute the payment order of a customer, or if the order is executed late. There also may be an error in the payment order issued by a bank that is executing the payment order of its customer. For example, the error might relate to the amount to be paid or to the identity of the person to be paid. Because the dollar amounts involved in funds transfers are so large, the risk of loss if something goes wrong in a transaction may also be very large. A major policy issue in the drafting of Article 4A (A.C.A. § 4-4A-101 et seq.) is that of determining how risk of loss is to be allocated given the price structure in the industry.

*Concept of acceptance and effect of acceptance by the beneficiary's bank.*

Rights and obligations under Article 4A (A.C.A. § 4-4A-101 et seq.) arise as the result of "acceptance" of a payment order by the bank to which the order is addressed. Section 4A-209 (A.C.A. § 4-4A-209). The effect of acceptance varies depending upon whether the payment order is issued to the beneficiary's bank or to a bank other than the beneficiary's bank. Acceptance by the beneficiary's bank is particularly important because it defines when the beneficiary's bank becomes obligated to the beneficiary to pay the amount of the payment order. Although Article 4A (A.C.A. § 4-4A-101 et seq.) follows convention in using the term "funds transfer" to identify the payment from X to Y that is described above, no money or property

right of X is actually transferred to Y. X pays Y by causing Y's bank to become indebted to Y in the amount of the payment. This debt arises when Y's bank accepts the payment order that X's bank issued to Y's bank to execute X's order. If the funds transfer was carried out by use of one or more intermediary banks between X's bank and Y's bank, Y's bank becomes indebted to Y when Y's bank accepts the payment order issued to it by an intermediary bank. The funds transfer is completed when this debt is incurred. Acceptance, the event that determines when the debt of Y's bank to Y arises, occurs (i) when Y's bank pays Y or notifies Y of receipt of the payment order, or (ii) when Y's bank receives payment from the bank that issued a payment order to Y's bank.

The only obligation of the beneficiary's bank that results from acceptance of a payment order is to pay the amount of the order to the beneficiary. No obligation is owed to either the sender of the payment order accepted by the beneficiary's bank or to the originator of the funds transfer. The obligation created by acceptance by the beneficiary's bank is for the benefit of the beneficiary. The purpose of the sender's payment order is to effect payment by the originator to the beneficiary and that purpose is achieved when the beneficiary's bank accepts the payment order. Section 4A-405 (A.C.A. § 4-4A-405) states rules for determining when the obligation of the beneficiary's bank to the beneficiary has been paid.

*Acceptance by a bank other than the beneficiary's bank.*

In the funds transfer described above, what is the obligation of X's bank when it receives X's payment order? Funds transfers by a bank on behalf of its customer are made pursuant to an agreement or arrangement that may or may not be reduced to a formal document signed by the parties. It is probably true that in most cases there is either no express agreement or the agreement addresses only some aspects of the transaction. Substantial risk is involved in funds transfers and a bank may not be willing to give this service to all customers, and may not be willing to offer it to any customer unless certain safeguards against loss such as security procedures are in effect. Funds

transfers often involve the giving of credit by the receiving bank to the customer, and that also may involve an agreement. These considerations are reflected in Article 4A (A.C.A. § 4-4A-101 et seq.) by the principle that, in the absence of a contrary agreement, a receiving bank does not incur liability with respect to a payment order until it accepts it. If X and X's bank in the hypothetical case had an agreement that obliged the bank to act on X's payment orders and the bank failed to comply with the agreement, the bank can be held liable for breach of the agreement. But apart from any obligation arising by agreement, the bank does not incur any liability with respect to X's payment order until the bank accepts the order. X's payment order is treated by Article 4A (A.C.A. § 4-4A-101 et seq.) as a request by X to the bank to take action that will cause X's payment order to be carried out. That request can be accepted by X's bank by "executing" X's payment order. Execution occurs when X's bank sends a payment order to Y's bank intended by X's bank to carry out the payment order of X. X's bank could also execute X's payment order by issuing a payment order to an intermediary bank instructing the intermediary bank to instruct Y's bank to make the credit to Y's account. In that case execution and acceptance of X's order occur when the payment order of X's bank is sent to the intermediary bank. When X's bank executes X's payment order the bank is entitled to receive payment from X and may debit an authorized account of X. If X's bank does not execute X's order and the amount of the order is covered by a withdrawable credit balance in X's authorized account, the bank must pay X interest on the money represented by X's order unless X is given prompt notice of rejection of the order. Section 4A-210(b) (A.C.A. § 4-4A-210(b)).

#### *Bank error in funds transfers.*

If a bank, other than the beneficiary's bank, accepts a payment order, the obligations and liabilities are owed to the originator of the funds transfer. Assume in the example stated above, that X's bank executes X's payment order by issuing a payment order to an intermediary bank that executes the order of X's bank by issuing a payment order to Y's bank. The obligations of X's bank with respect to execution

are owed to X. The obligations of the intermediary bank with respect to execution are also owed to X. Section 4A-302 (A.C.A. § 4-4A-302) states standards with respect to the time and manner of execution of payment orders. Section 4A-305 (A.C.A. § 4-4A-305) states the measure of damages for improper execution. It also states that a receiving bank is liable for damages if it fails to execute a payment order that it was obliged by express agreement to execute. In each case consequential damages are not recoverable unless an express agreement of the receiving bank provides for them. The policy basis for this limitation is discussed in Comment 2 to Section 4A-305 (A.C.A. § 4-4A-305).

Error in the consummation of a funds transfer is not uncommon. There may be a discrepancy in the amount that the originator orders to be paid to the beneficiary and the amount that the beneficiary's bank is ordered to pay. For example, if the originator's payment order instructs payment of \$100,000 and the payment order of the originator's bank instructs payment of \$1,000,000, the originator's bank is entitled to receive only \$100,000 from the originator and has the burden of recovering the additional \$900,000 paid to the beneficiary by mistake. In some cases the originator's bank or an intermediary bank instructs payment to a beneficiary other than the beneficiary stated in the originator's payment order. If the wrong beneficiary is paid the bank that issued the erroneous payment order is not entitled to receive payment of the payment order that it executed and has the burden of recovering the mistaken payment. The originator is not obliged to pay its payment order. Section 4A-303 and Section 4A-207 (A.C.A. §§ 4-4A-303 and 4-4A-207) state rules for determining the rights and obligations of the various parties to the funds transfer in these cases and in other typical cases in which error is made.

Pursuant to Section 4A-402(c) (A.C.A. § 4-4A-402(c)) the originator is excused from the obligation to pay the originator's bank if the funds transfer is not completed, i.e. payment by the originator to the beneficiary is not made. Payment by the originator to the beneficiary occurs when the beneficiary's bank accepts a payment order for the benefit of the beneficiary of the originator's payment order.



Section 4A-406 (A.C.A. § 4-4A-406). If for any reason that acceptance does not occur, the originator is not required to pay the payment order that it issued or, if it already paid, is entitled to refund of the payment with interest. This "money-back guarantee" is an important protection of the originator of a funds transfer. The same rule applies to any other sender in the funds transfer. Each sender's obligation to pay is excused if the beneficiary's bank does not accept a payment order for the benefit of the beneficiary of that sender's order. There is an important exception to this rule. It is common practice for the originator of a funds transfer to designate the intermediary bank or banks through which the funds transfer is to be routed. The originator's bank is required by Section 4A-302 (A.C.A. § 4-4A-302) to follow the instruction of the originator with respect to intermediary banks. If the originator's bank sends a payment order to the intermediary bank designated in the originator's order and the intermediary bank causes the funds transfer to miscarry by failing to execute the payment order or by instructing payment to the wrong beneficiary, the originator's bank is not required to pay its payment order and if it has already paid it is entitled to recover payment from the intermediary bank. This remedy is normally adequate, but if the originator's bank already paid its order and the intermediary bank has suspended payments or is not permitted by law to refund payment, the originator's bank will suffer a loss. Since the originator required the originator's bank to use the failed intermediary bank, Section 4A-402(e) (A.C.A. § 4-4A-402(e)) provides that in this case the originator is obliged to pay its payment order and has a claim against the intermediary bank for the amount of the order. The same principle applies to any other sender that designates a subsequent intermediary bank.

#### *Unauthorized payment orders.*

An important issue addressed in Section 4A-202 and Section 4A-203 (A.C.A. §§ 4-4A-202 and 4-4A-203) is how the risk of loss from unauthorized payment orders is to be allocated. In a large percentage of cases, the payment order of the originator of the funds transfer is transmitted electronically to the originator's bank. In these cases it may not be possible for the

bank to know whether the electronic message has been authorized by its customer. To ensure that no unauthorized person is transmitting messages to the bank, the normal practice is to establish security procedures that usually involve the use of codes or identifying numbers or words. If the bank accepts a payment order that purports to be that of its customer after verifying its authenticity by complying with a security procedure agreed to by the customer and the bank, the customer is bound to pay the order even if it was not authorized. But there is an important limitation on this rule. The bank is entitled to payment in the case of an unauthorized order only if the court finds that the security procedure was a commercially reasonable method of providing security against unauthorized payment orders. The customer can also avoid liability if it can prove that the unauthorized order was not initiated by an employee or other agent of the customer having access to confidential security information or by a person who obtained that information from a source controlled by the customer. The policy issues are discussed in the comments following Section 4A-203 (A.C.A. § 4-4A-203). If the bank accepts an unauthorized payment order without verifying it in compliance with a security procedure, the loss falls on the bank.

Security procedures are also important in cases of error in the transmission of payment orders. There may be an error by the sender in the amount of the order, or a sender may transmit a payment order and then erroneously transmit a duplicate of the order. Normally, the sender is bound by the payment order even if it is issued by mistake. But in some cases an error of this kind can be detected by a security procedure. Although the receiving bank is not obliged to provide a security procedure for the detection of error, if such a procedure is agreed to be the bank Section 4A-205 (A.C.A. § 4-4A-205) provides that if the error is not detected because the receiving bank does not comply with the procedure, any resulting loss is borne by the bank failing to comply with the security procedure.

#### *Insolvency losses.*

Some payment orders do not involve the granting of credit to the sender by the receiving bank. In those cases, the receiv-

ing bank accepts the sender's order at the same time the bank receives payment of the order. This is true of a transfer of funds by Fedwire or of cases in which the receiving bank can debit a funded account of the sender. But in some cases the granting of credit is the norm. This is true of a payment order over CHIPS. In a CHIPS transaction the receiving bank usually will accept the order before receiving payment from the sending bank. Payment is delayed until the end of the day when settlement is made through the Federal Reserve System. If the receiving bank is an intermediary bank, it will accept by issuing a payment order to another bank and the intermediary bank is obliged to pay that payment order. If the receiving bank is the beneficiary's bank, the bank usually will accept by releasing funds to the beneficiary before the bank has received payment. If a sending bank suspends payments before settling its liabilities at the end of the day, the financial stability of banks that are net creditors of the insolvent bank may also be put into jeopardy, because the dollar volume of funds transfers between the banks may be extremely large. With respect to two banks that are dealing with each other in a series of transactions in which each bank is sometimes a receiving bank and sometimes a sender, the risk of insolvency can be managed if amounts payable as a sender and amounts receivable as a receiving bank are roughly equal. But if these amounts are significantly out of balance, a net creditor bank may have a very significant credit risk during the day before settlement occurs. The Federal Reserve System and the banking community are greatly concerned with this risk, and various measures have been instituted to reduce this credit exposure. Article 4A (A.C.A. § 4-4A-101 et seq.) also addresses this problem. A receiving bank can always avoid this risk by delaying acceptance of a payment order until after the bank has received payment. For example, if the beneficiary's bank credits the beneficiary's account it can avoid acceptance by not notifying the beneficiary of the receipt of the order or by notifying the beneficiary that the credit may not be withdrawn

until the beneficiary's bank receives payment. But if the beneficiary's bank releases funds to the beneficiary before receiving settlement, the result in a funds transfer other than a transfer by means of an automated clearing house or similar provisional settlement system is that the beneficiary's bank may not recover the funds if it fails to receive settlement. This rule encourages the banking system to impose credit limitations on banks that issue payment orders. These limitations are already in effect. CHIPS has also proposed a loss-sharing plan to be adopted for implementation in the second half of 1990 under which CHIPS participants will be required to provide funds necessary to complete settlement of the obligations of one or more participants that are unable to meet settlement obligations. Under this plan, it will be a virtual certainty that there will be settlement on CHIPS in the event of a failure by a single bank. Section 4A-403(b) and (c) (A.C.A. § 4-4A-403(b) and (c)) are also addressed to reducing risks of insolvency. Under these provisions the amount owed by a failed bank with respect to payment orders it issued is the net amount owing after setting off amounts owed to the failed bank with respect to payment orders it received. This rule allows credit exposure to be managed by limitations on the net debit position of a bank.

#### *International transfers.*

The major international legal document dealing with the subject of electronic funds transfers is the Model Law on International Credit Transfers adopted in 1992 by the United Nations Commission on International Trade Law. It covers basically the same type of transaction as does Article 4A (A.C.A. § 4-4A-101 et seq.), although it requires the funds transferred to have an international component. The Model Law and Article 4A (A.C.A. § 4-4A-101 et seq.) basically live together in harmony, but to the extent there are differences they must be recognized and, to the extent possible, avoided or adjusted by agreement. See PEB Commentary No. 13, dated February 16, 1994 [Appendix II at end of Volume 3B].



**Comment to § 4A-102 (A.C.A. § 4-4A-102)**

Article 4A (A.C.A. § 4-4A-101 et seq.) governs a specialized method of payment referred to in the article as a funds transfer but also commonly referred to in the commercial community as a wholesale wire transfer. A funds transfer is made by means of one or more payment orders. The scope of Article 4A (A.C.A. § 4-4A-101 et seq.) is determined by the definitions of "payment order" and "funds transfer" found in Section 4A-103 and Section 4A-104 (A.C.A. §§ 4-4A-103 and 4-4A-104).

The funds transfer governed by Article 4A (A.C.A. § 4-4A-101 et seq.) is in large part a product of recent and developing technological changes. Before this Article (Chapter) (A.C.A. § 4-4A-101 et seq.) was drafted there was no comprehensive body of law—statutory or judicial—that defined the juridical nature of a funds transfer or the rights and obligations flowing from payment orders. Judicial authority with respect to funds transfers is sparse, undeveloped and not uniform. Judges have had to resolve disputes by referring to general principles of common law or equity, or they have sought guidance in statutes such as Article 4 (A.C.A. § 4-4-101 et seq.) which are applicable to other payment methods. But attempts to define rights and obligations in funds transfers by general principles or by analogy to rights and obligations in negotiable instrument law or the law of check collection have not been satisfactory.

In the drafting of Article 4A (A.C.A. § 4-4A-101 et seq.), a deliberate decision was made to write on a clean slate and to treat a funds transfer as a unique method of payment to be governed by unique rules

that address the particular issues raised by this means of payment. A deliberate decision was also made to use precise and detailed rules to assign responsibility, define behavioral norms, allocate risks and establish limits on liability rather than to rely on broadly stated, flexible principles. In the drafting of these rules, a critical consideration was that the various parties to funds transfers need to be able to predict risk with certainty to insure against risk to adjust operational and security procedures and to price funds transfer services appropriately. This consideration is particularly important given the very large amounts of money that are involved in funds transfers.

Funds transfers involve competing interests—those of the banks that provide funds transfer services and the commercial and financial organizations that use the services as well as the public interest. These competing interests were represented in the drafting process and they were thoroughly considered. The rules that emerged represent a careful and delicate balancing of these interests and are intended to be the exclusive means of determining the rights, duties and liabilities of the affected parties in any situation covered by particular provisions of the Article (Chapter) (A.C.A. § 4-4A-101 et seq.). Consequently, resort to principles of law or equity outside of Article 4A (A.C.A. § 4-4A-101 et seq.) is not appropriate to create rights, duties and liabilities inconsistent with those stated in this Article (Chapter) (A.C.A. § 4-4A-101 et seq.).

**Comment to § 4A-103 (A.C.A. § 4-4A-103)**

This section (A.C.A. § 4-4A-103) is discussed in the Comment following Section 4A-104 (A.C.A. § 4-4A-104).

**Comment to § 4A-104 (A.C.A. § 4-4A-104)**

1. Article 4A (A.C.A. § 4-4A-101 et seq.) governs a method of payment in which the person making payment (the "originator") directly transmits an instruction to a bank either to make payment to the person receiving payment (the

"beneficiary") or to instruct some other bank to make payment to the beneficiary. The payment from the originator to the beneficiary occurs when the bank that is to pay the beneficiary becomes obligated to pay the beneficiary. There are two basic

definitions: "Payment order" stated in Section 4A-103 (A.C.A. § 4-4A-103) and "Funds transfer" stated in Section 4A-104 (A.C.A. § 4-4A-104). These definitions, other related definitions, and the scope of Article 4A (A.C.A. § 4-4A-101 et seq.) can best be understood in the context of specific fact situations. Consider the following cases:

*Case # 1.* X, which has an account in Bank A, instructs that bank to pay \$1,000,000 to Y's account in Bank A. Bank A carries out X's instruction by making a credit of \$1,000,000 to Y's account and notifying Y that the credit is available for immediate withdrawal. The instruction by X to Bank A is a "payment order" which was issued when it was sent to Bank A. Section 4A-103(a)(1) and (c) (A.C.A. § 4-4A-103(a)(1) and (c)). X is the "sender" of the payment order and Bank A is the "receiving bank." Section 4A-103(a)(5) and (a)(4) (A.C.A. § 4-4A-103(a)(5) and (a)(4)). Y is the "beneficiary" of the payment order and Bank A is the "beneficiary's bank." Section 4A-103(a)(2) and (a)(3) (A.C.A. § 4-4A-103(a)(2) and (a)(3)). When Bank A notified Y of receipt of the payment order, Bank A "accepted" the payment order. Section 4A-209(b)(1) (A.C.A. § 4-4A-209(b)(1)). When Bank A accepted the order it incurred an obligation to Y to pay the amount of the order. Section 4A-404(a) (A.C.A. § 4-4A-404(a)). When Bank A accepted X's order, X incurred an obligation to pay Bank A the amount of the order. Section 4A-402(b) (A.C.A. § 4-4A-402(b)). Payment from X to Bank A would normally be made by a debit to X's account in Bank A. Section 4A-403(a)(3) (A.C.A. § 4-4A-403(a)(3)). At the time Bank A incurred the obligation to pay Y, payment of \$1,000,000 by X to Y was also made. Section 4A-406(a) (A.C.A. § 4-4A-406(a)). Bank A paid Y when it gave notice to Y of a withdrawable credit of \$1,000,000 to Y's account. Section 4A-405(a) (A.C.A. § 4-4A-405(a)). The overall transaction, which comprises the acts of X and Bank A, in which the payment by X to Y is accomplished is referred to as the "funds transfer."

Section 4A-104(a) (A.C.A. § 4-4A-104(a)). In this case only one payment order was involved in the funds transfer. A one-payment-order funds transfer is usually referred to as a "book transfer" because the payment is accomplished by the receiving bank's debiting the account of the sender and crediting the account of the beneficiary in the same bank. X, in addition to being the sender of the payment order to Bank A, is the "originator" of the funds transfer. Section 4A-104(c) (A.C.A. § 4-4A-104(c)). Bank A is the "originator's bank" in the funds transfer as well as the beneficiary's bank. Section 4A-104(d) (A.C.A. § 4-4A-104(d)).

*Case # 2.* Assume the same facts as in Case # 1 except that X instructs Bank A to pay \$1,000,000 to Y's account in Bank B. With respect to this payment order, X is the sender, Y is the beneficiary, and Bank A is the receiving bank. Bank A carries out X's order by instructing Bank B to pay \$1,000,000 to Y's account. This instruction is a payment order in which Bank A is the sender, Bank B is the receiving bank, and Y is the beneficiary. When Bank A issued its payment order to Bank B, Bank A "executed" X's order. Section 4A-301(a) (A.C.A. § 4-4A-301(a)). In the funds transfer, X is the originator, Bank A is the originator's bank, and Bank B is the beneficiary's bank. When Bank A executed X's order, X incurred an obligation to pay Bank A the amount of the order. Section 4A-402(c) (A.C.A. § 4-4A-402(c)). When Bank B accepts the payment order issued to it by Bank A, Bank B incurs an obligation to Y to pay the amount of the order (Section 4A-404(a)) (A.C.A. § 4-4A-404(a)) and Bank A incurs an obligation to pay Bank B. Section 4A-402(b) (A.C.A. § 4-4A-402(b)). Acceptance by Bank B also results in payment of \$1,000,000 by X to Y. Section 4A-406(a) (A.C.A. § 4-4A-406(a)). In this case two payment orders are involved in the funds transfer.

*Case # 3.* Assume the same facts as in Case # 2 except that Bank A does not execute X's payment order by issuing



a payment order to Bank B. One bank will not normally act to carry out a funds transfer for another bank unless there is a preexisting arrangement between the banks for transmittal of payment orders and settlement of accounts. For example, if Bank B is a foreign bank with which Bank A has no relationship, Bank A can utilize a bank that is a correspondent of both Bank A and Bank B. Assume Bank A issues a payment order to Bank C to pay \$1,000,000 to Y's account in Bank B. With respect to this order, Bank A is the sender, Bank C is the receiving bank, and Y is the beneficiary. Bank C will execute the payment order of Bank A by issuing a payment order to Bank B to pay \$1,000,000 to Y's account in Bank B. With respect to Bank C's payment order, Bank C is the sender, Bank B is the receiving bank, and Y is the beneficiary. Payment of \$1,000,000 by X to Y occurs when Bank B accepts the payment order issued to it by Bank C. In this case the funds transfer involves three payment orders. In the funds transfer, X is the originator, Bank A is the originator's bank, Bank B is the beneficiary's bank, and Bank C is an "intermediary bank." Section 4A-104(b) (A.C.A. § 4-4A-104(b)). In some cases there may be more than one intermediary bank, and in those cases each intermediary bank is treated like Bank C in Case # 3.

As the three cases demonstrate, a payment under Article 4A (A.C.A. § 4-4A-101 et seq.) involves an overall transaction, the funds transfer, in which the originator, X, is making payment to the beneficiary, Y, but the funds transfer may encompass a series of payment orders that are issued in order to effect the payment initiated by the originator's payment order.

In some cases the originator and the beneficiary may be the same person. This will occur, for example, when a corporation orders a bank to transfer funds from an account of the corporation in that bank to another account of the corporation in that bank or in some other bank. In some funds transfers the first bank to issue a payment order is a bank that is executing a payment order of a customer that is not

a bank. In this case the customer is the originator. In other cases, the first bank to issue a payment order is not acting for a customer, but is making a payment for its own account. In that event the first bank to issue a payment order is the originator as well as the originator's bank.

2. "Payment order" is defined in Section 4A-103(a)(1) (A.C.A. § 4-4A-103(a)(1)) as an instruction to a bank to pay, or to cause another bank to pay, a fixed or determinable amount of money. The bank to which the instruction is addressed is known as the "receiving bank." Section 4A-103(a)(4) (A.C.A. § 4-4A-103(a)(4)). "Bank" is defined in Section 4A-105(a)(2) (A.C.A. § 4-4A-105(a)(2)). The effect of this definition is to limit Article 4A (A.C.A. § 4-4A-101 et seq.) to payments made through the banking system. A transfer of funds made by an entity outside the banking system is excluded. A transfer of funds through an entity other than a bank is usually a consumer transaction involving relatively small amounts of money and a single contract carried out by transfers of cash or a cash equivalent such as a check. Typically, the transferor delivers cash or a check to the company making the transfer, which agrees to pay a like amount to a person designated by the transferor. Transactions covered by Article 4A (A.C.A. § 4-4A-101 et seq.) typically involve very large amounts of money in which several transactions involving several banks may be necessary to carry out the payment. Payments are normally made by debits or credits to bank accounts. Originators and beneficiaries are almost always business organizations and the transfers are usually made to pay obligations. Moreover, these transactions are frequently done on the basis of very short-term credit granted by the receiving bank to the sender of the payment order. Wholesale wire transfers involve policy questions that are distinct from those involved in consumer-based transactions by nonbanks.

3. Further limitations on the scope of Article 4A (A.C.A. § 4-4A-101 et seq.) are found in the three requirements found in subparagraphs (i), (ii), and (iii) of Section 4A-103(a)(1) (A.C.A. § 4-4A-103(a)(1)(i), (ii), and (iii)). Subparagraph (i) (A.C.A. § 4-4A-103(a)(1)(i)) states that the instruction to pay is a payment order only if it "does not state a condition to payment to

the beneficiary other than time of payment." An instruction to pay a beneficiary sometimes is subject to a requirement that the beneficiary perform some act such as delivery of documents. For example, a New York bank may have issued a letter of credit in favor of X, a California seller of goods to be shipped to the New York bank's customer in New York. The terms of the letter of credit provide for payment to X if documents are presented to prove shipment of the goods. Instead of providing for presentment of the documents to the New York bank, the letter of credit states that they may be presented to a California bank that acts as an agent for payment. The New York bank sends an instruction to the California bank to pay X upon presentation of the required documents. The instruction is not covered by Article 4A (A.C.A. § 4-4A-101 et seq.) because payment to the beneficiary is conditional upon receipt of shipping documents. The function of banks in a funds transfer under Article 4A (A.C.A. § 4-4A-101 et seq.) is comparable to the role of banks in the collection and payment of checks in that it is essentially mechanical in nature. The low price and high speed that characterize funds transfers reflect this fact. Conditions to payment by the California bank other than time of payment impose responsibilities on that bank that go beyond those in Article 4A (A.C.A. § 4-4A-101 et seq.) funds transfers. Although the payment by the New York bank to X under the letter of credit is not covered by Article 4A (A.C.A. § 4-4A-101 et seq.), if X is paid by the California bank, payment of the obligation of the New York bank to reimburse the California bank could be made by an Article 4A (A.C.A. § 4-4A-101 et seq.) funds transfer. In such a case there is a distinction between the payment by the New York bank to X under the letter of credit and the payment by the New York bank to the California bank. For example, if the New York bank pays its reimbursement obligation to the California bank by a Fedwire naming the California bank as beneficiary (See Comment 1 to Section 4A-107 (A.C.A. § 4-4A-107)), payment is made to the California bank rather than to X. That payment is governed by Article 4A (A.C.A. § 4-4A-101 et seq.) and could be made either before or after payment by the California bank to X. The payment by the New York bank to X under the letter of

credit is not governed by Article 4A (A.C.A. § 4-4A-101 et seq.) and it occurs when the California bank, as agent of the New York bank, pays X. No payment order was involved in that transaction. In this example, if the New York bank had erroneously sent an instruction to the California bank unconditionally instructing payment to X, the instruction would have been an Article 4A (A.C.A. § 4-4A-101 et seq.) payment order. If the payment order was accepted (Section 4A-209(b)) (A.C.A. § 4-4A-209(b)) by the California bank, a payment by the New York bank to X would have resulted (Section 4A-406(a)) (A.C.A. § 4-4A-406(a)). But Article 4A (A.C.A. § 4-4A-101 et seq.) would not prevent recovery of funds from X on the basis that X was not entitled to retain the funds under the law of mistake and restitution, letter of credit law or other applicable law.

4. Transfers of funds made through the banking system are commonly referred to as either "credit" transfers or "debit" transfers. In a credit transfer the instruction to pay is given by the person making payment. In a debit transfer the instruction to pay is given by the person receiving payment. The purpose of subparagraph (ii) of subsection (a)(1) of Section 4A-103 (A.C.A. § 4-4A-103(a)(1)(ii)) is to include credit transfers in Article 4A (A.C.A. § 4-4A-101 et seq.) and to exclude debit transfers. All of the instructions to pay in the three cases described in Comment 1 fall within subparagraph (ii) (A.C.A. § 4-4A-103(a)(1)(ii)). Take Case # 2 as an example. With respect to X's instruction given to Bank A, Bank A will be reimbursed by debiting X's account or otherwise receiving payment from X. With respect to Bank A's instruction to Bank B, Bank B will be reimbursed by receiving payment from Bank A. In a debit transfer, a creditor, pursuant to authority from the debtor, is enabled to draw on the debtor's bank account by issuing an instruction to pay to the debtor's bank. If the debtor's bank pays, it will be reimbursed by the debtor rather than by the person giving the instruction. For example, the holder of an insurance policy may pay premiums by authorizing the insurance company to order the policyholder's bank to pay the insurance company. The order to pay may be in the form of a draft covered by Article 3 (A.C.A. § 4-3-101 et seq.), or it might be an instruction to pay that is not an instru-



ment under that Article (Chapter). The bank receives reimbursement by debiting the policyholder's account. Or, a subsidiary corporation may make payments to its parent by authorizing the parent to order the subsidiary's bank to pay the parent from the subsidiary's account. These transactions are not covered by Article 4A (A.C.A. § 4-4A-101 et seq.) because subparagraph (2) (A.C.A. § 4-4A-103(a)(2)) is not satisfied. Article 4A (A.C.A. § 4-4A-101 et seq.) is limited to transactions in which the account to be debited by the receiving bank is that of the person in whose name the instruction is given.

If the beneficiary of a funds transfer is the originator of the transfer, the transfer is governed by Article 4A (A.C.A. § 4-4A-101 et seq.) if it is a credit transfer in form. If it is in the form of a debit transfer it is not governed by Article 4A (A.C.A. § 4-4A-101 et seq.). For example, Corporation has accounts in Bank A and Bank B. Corporation instructs Bank A to pay to Corporation's account in Bank B. The funds transfer is governed by Article 4A (A.C.A. § 4-4A-101 et seq.). Sometimes, Corporation will authorize Bank B to draw on Corporation's account in Bank A for the purpose of transferring funds into Corporation's account in Bank B. If Corporation also makes an agreement with Bank A under which Bank A is authorized to follow instructions of Bank B, as agent of corporation, to transfer funds from Customer's account in Bank A, the instruction of Bank B is a payment order of Customer and is governed by Article 4A (A.C.A. § 4-4A-101 et seq.). This kind of transaction is known in the wire-transfer business as a "drawdown transfer." If Corporation does not make such an agreement with Bank A and Bank B instructs Bank A to make the transfer, the order is in form a debit transfer and is not governed by Article 4A (A.C.A. § 4-4A-101 et seq.). These debit transfers are normally ACH transactions in which Bank A relies on Bank B's warranties pursuant to ACH rules, including the warranty that the transfer is authorized.

5. The principal effect of subparagraph (iii) of subsection (a) of Section 4A-103 (A.C.A. § 4-4A-103(a)(1)(iii)) is to exclude from Article 4A (A.C.A. § 4-4A-101 et seq.) payments made by check or credit card. In those cases the instruction of the

debtor to the bank on which the check is drawn or to which the credit card slip is to be presented is contained in the check or credit card slip signed by the debtor. The instruction is not transmitted by the debtor directly to the debtor's bank. Rather, the instruction is delivered or otherwise transmitted by the debtor to the creditor who then presents it to the bank either directly or through bank collection channels. These payments are governed by Articles 3 and 4 (A.C.A. § 4-3-101 et seq. and § 4-4-101 et seq.) and federal law. There are, however, limited instances in which the paper on which a check is printed can be used as the means of transmitting a payment order that is covered by Article 4A (A.C.A. § 4-4A-101 et seq.). Assume that Originator instructs Originator's Bank to pay \$10,000 to the account of Beneficiary in Beneficiary's Bank. Since the amount of Originator's payment order is small, if Originator's Bank and Beneficiary's Bank do not have an account relationship, Originator's Bank may execute Originator's order by issuing a teller's check payable to Beneficiary's Bank for \$10,000 along with instructions to credit Beneficiary's account in that amount. The instruction to Beneficiary's Bank to credit Beneficiary's account is a payment order. The check is the means by which Originator's Bank pays its obligation as sender of the payment order. The instruction of Originator's Bank to Beneficiary's Bank might be given in a letter accompanying the check or it may be written on the check itself. In either case the instruction to Beneficiary's Bank is a payment order but the check itself (which is an order to pay addressed to the drawee rather than to Beneficiary's Bank) is an instrument under Article 3 (A.C.A. § 4-3-101 et seq.) and is not a payment order. The check can be both the means by which Originator's Bank pays its obligation under § 4A-402(b) (A.C.A. § 4-4A-402(b)) to Beneficiary's Bank and the means by which the instruction to Beneficiary's Bank is transmitted.

6. Most payments covered by Article 4A (A.C.A. § 4-4A-101 et seq.) are commonly referred to as wire transfers and usually involve some kind of electronic transmission, but the applicability of Article 4A (A.C.A. § 4-4A-101 et seq.) does not depend upon the means used to transmit the instruction of the sender. Transmission

may be by letter or other written communication, oral communication or electronic communication. An oral communication is normally given by telephone. Frequently the message is recorded by the receiving bank to provide evidence of the transaction, but apart from problems of proof there is no need to record the oral instruction.

Transmission of an instruction may be a direct communication between the sender and the receiving bank or through an intermediary such as an agent of the sender, a communication system such as international cable, or a funds transfer system such as CHIPS, SWIFT or an automated clearing house.

### Comment to § 4A-105 (A.C.A. § 4-4A-105)

1. The definition of "bank" in subsection (a)(2) (A.C.A. § 4-4A-105(a)(2)) includes some institutions that are not commercial banks. The definition reflects the fact that many financial institutions now perform functions previously restricted to commercial banks, including acting on behalf of customers in funds transfers. Since many funds transfers involve payment orders to or from foreign countries the definition also covers foreign banks. The definition also includes Federal Reserve Banks. Funds transfers carried out by Federal Reserve Banks are described in Comments 1 and 2 to Section 4A-107 (A.C.A. § 4-4A-107).

2. Funds transfer business is frequently transacted by banks outside of general banking hours. Thus, the definition of banking day in Section 4-104(1)(c) (A.C.A. § 4-104(1)(c)) cannot be used to describe when a bank is open for funds transfer business. Subsection (a)(4) (A.C.A. § 4-4A-105(a)(4)) defines a new term, "funds transfer business day," which is applicable to Article 4A (A.C.A. § 4-4A-101 et seq.). The definition states, "is open for the receipt, processing, and transmittal of payment orders and cancellations and amendments of payment orders." In some cases it is possible to electronically transmit payment orders and other communications to a receiving bank at any time. If the receiving bank is not open for the processing of an order when it is received, the communication is stored in the receiving bank's computer for retrieval when the receiving bank is open for processing. The use of the conjunctive makes clear that the defined term is limited to the period during which all functions of the receiving bank can be performed, i.e., receipt, processing, and transmittal of payment orders, cancellations and amendments.

3. Subsection (a)(5) (A.C.A. § 4-4A-

105(a)(5)) defines "funds transfer system." The term includes a system such as CHIPS which provides for transmission of a payment order as well as settlement of the obligation of the sender to pay the order. It also includes automated clearing houses, operated by a clearing house or other association of banks, which process and transmit payment orders of banks to other banks. In addition the term includes organizations that provide only transmission services such as SWIFT. The definition also includes the wire transfer network and automated clearing houses of Federal Reserve Banks. Systems of the Federal Reserve Banks, however, are treated differently from systems of other associations of banks. Funds transfer systems other than systems of the Federal Reserve Banks are treated in Article 4A (A.C.A. § 4-4A-101 et seq.) as a means of communication of payment orders between participating banks. Section 4A-206 (A.C.A. § 4-4A-206). The Comment to that section and the Comment to Section 4A-107 (A.C.A. § 4-4A-107) explain how Federal Reserve Banks function under Article 4A (A.C.A. § 4-4A-101 et seq.). Funds transfer systems are also able to promulgate rules binding on participating banks that, under Section 4A-501 (A.C.A. § 4-4A-501), may supplement or in some cases may even override provisions of Article 4A (A.C.A. § 4-4A-101 et seq.).

4. Subsection (d) (A.C.A. § 4-4A-105(d)) incorporates definitions stated in Article 1 (A.C.A. § 4-1-101 et seq.) as well as principles of construction and interpretation stated in that Article (Chapter). Included is Section 1-103 (A.C.A. § 4-1-103). The last paragraph of the Comment to Section 4A-102 (A.C.A. § 4-4A-102) is addressed to the issue of the extent to which general principles of law and equity should apply to situations covered by provisions of Article 4A (A.C.A. § 4-4A-101 et seq.).



**Comment to § 4A-106 (A.C.A. § 4-4A-106)**

The time that a payment order is received by a receiving bank usually defines the payment date or the execution date of a payment order. Section 4A-401 and Section 4A-301 (A.C.A. §§ 4-4A-401 and 4-4A-301). The time of receipt of a payment order, or communication canceling or amending a payment order is defined in

subsection (a) (A.C.A. § 4-4A-106(a)) by reference to the rules stated in Section 1-201(27) (A.C.A. § 4-1-201(27)). Thus, time of receipt is determined by the same rules that determine when a notice is received. Time of receipt, however, may be altered by a cut-off time.

**Comment to § 4A-107 (A.C.A. § 4-4A-107)**

1. Funds transfers under Article 4A (A.C.A. § 4-4A-101 et seq.) may be made, in whole or in part, by payment orders through a Federal Reserve Bank in what is usually referred to as a transfer by Fedwire. If Bank A, which has an account in Federal Reserve Bank X, wants to pay \$1,000,000 to Bank B, which has an account in Federal Reserve Bank Y, Bank A can issue an instruction to Reserve Bank X requesting a debit of \$1,000,000 to Bank A's Reserve account and an equal credit to Bank B's Reserve account. Reserve Bank X will debit Bank A's account and will credit the account of Reserve Bank Y. Reserve Bank X will issue an instruction to Reserve Bank Y requesting a debit of \$1,000,000 to the account of Reserve Bank X and an equal credit to Bank B's account in Reserve Bank Y. Reserve Bank Y will make the requested debit and credit and will give Bank B an advice of credit. The definition of "bank" in Section 4A-105(a)(2) (A.C.A. § 4-4A-105(a)(2)) includes both Reserve Bank X and Reserve Bank Y. Bank A's instruction to Reserve Bank X to pay money to Bank B is a payment order under Section 4A-103(a)(1) (A.C.A. § 4-4A-103(a)(1)). Bank A is the sender and Reserve Bank X is the receiving bank. Bank B is the beneficiary of Bank A's order and of the funds transfer. Bank A is the originator of the funds transfer and is also the originator's bank. Section 4A-104(c) and (d) (A.C.A. § 4-4A-104(c) and (d)). Reserve Bank X, an intermediary bank under Section 4-4A-104(b) (A.C.A. § 4-4A-104(b)), executes Bank A's order by sending a payment order to Reserve Bank Y instructing that bank to credit the Federal Reserve account of Bank B. Reserve Bank Y is the beneficiary's bank.

Suppose the transfer of funds from

Bank A to Bank B is part of a larger transaction in which Originator, a customer of Bank A, wants to pay Beneficiary, a customer of Bank B. Originator issues a payment order to Bank A to pay \$1,000,000 to the account of Beneficiary in Bank B. Bank A may execute Originator's order by means of Fedwire which simultaneously transfers \$1,000,000 from Bank A to Bank B and carries a message instructing Bank B to pay \$1,000,000 to the account of Y. The Fedwire transfer is carried out as described in the previous paragraph, except that the beneficiary of the funds transfer is Beneficiary rather than Bank B. Reserve Bank X and Reserve Bank Y are intermediary banks. When Reserve Bank Y advises Bank B of the credit to its Federal Reserve account it will also instruct Bank B to pay to the account of Beneficiary. The instruction is a payment order to Bank B which is the beneficiary's bank. When Reserve Bank Y advises Bank B of the credit to its Federal Reserve account Bank B receives payment of the payment order issued to it by Reserve Bank Y. Section 4A-403(a)(1) (A.C.A. § 4-4A-403(a)(1)). The payment order is automatically accepted by Bank B at the time it receives the payment order of Reserve Bank Y. Section 4A-209(b)(2) (A.C.A. § 4-4A-209(b)(2)). At the time of acceptance by Bank B payment by Originator to Beneficiary also occurs. Thus, in a Fedwire transfer, payment to the beneficiary's bank, acceptance by the beneficiary's bank and payment by the originator to the beneficiary all occur simultaneously by operation of law at the time the payment order to the beneficiary's bank is received.

If Originator orders payment to the account of Beneficiary in Bank C rather than Bank B, the analysis is somewhat

modified. Bank A may not have any relationship with Bank C and may not be able to make payment directly to Bank C. In that case, Bank A could send a Fedwire instructing Bank B to instruct Bank C to pay Beneficiary. The analysis is the same as the previous case except that Bank B is an intermediary bank and Bank C is the beneficiary's bank.

2. A funds transfer can also be made through a Federal Reserve Bank in an automated clearing house transaction. In a typical case, Originator instructs Originator's Bank to pay to the account of Beneficiary in Beneficiary's Bank. Originator's instruction to pay a particular beneficiary is transmitted to Originator's Bank along with many other instructions for payment to other beneficiaries by many different beneficiary's banks. All of these instructions are contained in a magnetic tape or other electronic device. Transmission of instructions to the various beneficiary's banks requires that Originator's instructions be processed and repackaged with instructions of other originators so that all instructions to a particular beneficiary's bank are transmitted together to that bank. The repackaging is done in processing centers usually referred to as automated clearing houses. Automated clearing houses are operated either by Federal Reserve Banks or by other associations of banks. If Originator's Bank chooses to execute Originator's instructions by transmitting them to a Federal Reserve Bank for processing by the Federal Reserve Bank, the transmission to the Federal Reserve Bank results in the issuance of payment orders by Originator's Bank to the Federal Reserve Bank, which is an intermediary bank.

Processing by the Federal Reserve Bank will result in the issuance of payment orders by the Federal Reserve Bank to Beneficiary's Bank as well as payment orders to other beneficiary's banks making payments to carry out Originator's instructions.

3. Although the terms of Article 4A (A.C.A. § 4-4A-101 et seq.) apply to funds transfers involving Federal Reserve Banks, federal preemption would make ineffective any Article 4A (A.C.A. § 4-4A-101 et seq.) provision that conflicts with federal law. The payments activities of the Federal Reserve Banks are governed by regulations of the Federal Reserve Board and by operating circulars issued by the Reserve Banks themselves. In some instances, the operating circulars are issued pursuant to a Federal Reserve Board regulation. In other cases, the Reserve Bank issues the operating circular under its own authority under the Federal Reserve Act, subject to review by the Federal Reserve Board. Section 4A-107 (A.C.A. § 4-4A-107) states that Federal Reserve Board regulations and operating circulars of the Federal Reserve Banks supersede any inconsistent provision of Article 4A (A.C.A. § 4-4A-101 et seq.) to the extent of the inconsistency. Federal Reserve Board regulations, being valid exercises of regulatory authority pursuant to a federal statute, take precedence over state law if there is an inconsistency. *Childs v. Federal Reserve Bank of Dallas*, 719 F.2d 812 (5th Cir. 1983), reh. den. 724 F.2d 127 (5th Cir. 1984). Section 4A-107 (A.C.A. § 4-4A-107) treats operating circulars as having the same effect whether issued under the Reserve Bank's own authority or under a Federal Reserve Board regulation.

#### Comment to § 4A-108 (A.C.A. § 4-4A-108)

The Electronic Fund Transfer Act of 1978 is a federal statute that covers a wide variety of electronic funds transfers involving consumers. The types of transfers covered by the federal statute are essentially different from the wholesale wire transfers that are the primary focus of Article 4A (A.C.A. § 4-4A-101 et seq.). Section 4A-108 (A.C.A. § 4-4A-108) excludes a funds transfer from Article 4A (A.C.A. § 4-4A-101 et seq.) if any part of the transfer is covered by the federal law. Existing procedures designed to comply

with federal law will not be affected by Article 4A (A.C.A. § 4-4A-101 et seq.). The effect of Section 4A-108 (A.C.A. § 4-4A-108) is to make Article 4A (A.C.A. § 4-4A-101 et seq.) and EFTA mutually exclusive. For example, if a funds transfer is to a consumer account in the beneficiary's bank and the funds transfer is made in part by use of Fedwire and in part by means of an automated clearing house, EFTA applies to the ACH part of the transfer but not to the Fedwire part. Under Section 4A-108 (A.C.A. § 4-4A-108),



Article 4A (A.C.A. § 4-4A-101 et seq.) does not apply to any part of the transfer. However, in the absence of any law to govern the part of the funds transfer that

is not subject to EFTA, a court might apply appropriate principles from Article 4A (A.C.A. § 4-4A-101 et seq.) by analogy.

#### **Comment to § 4A-201 (A.C.A. § 4-4A-201)**

A large percentage of payment orders and communications amending or canceling payment orders are transmitted electronically and it is standard practice to use security procedures that are designed to assure the authenticity of the message. Security procedures can also be used to detect error in the content of messages or to detect payment orders that are transmitted by mistake as in the case of multiple transmission of the same payment order. Security procedures might also apply to communications that are transmitted by telephone or in writing. Section 4A-201 (A.C.A. § 4-4A-201) defines these security procedures. The definition of security procedure limits the term to a procedure "established by agreement of a

customer and a receiving bank." The term does not apply to procedures that the receiving bank may follow unilaterally in processing payment orders. The question of whether loss that may result from the transmission of a spurious or erroneous payment order will be borne by the receiving bank or the sender or purported sender is affected by whether a security procedure was or was not in effect and whether there was or was not compliance with the procedure. Security procedures are referred to in Sections 4A-202 and 4A-203 (A.C.A. §§ 4-4A-202 and 4-4A-203), which deal with authorized and verified payment orders, and Section 4A-205 (A.C.A. § 4-4A-205), which deals with erroneous payment orders.

#### **Comment to § 4A-202 (A.C.A. § 4-4A-202)**

This section (A.C.A. § 4-4A-202) is discussed in the Comment following Section 4A-203 (A.C.A. § 4-4A-203).

#### **Comment to § 4A-203 (A.C.A. § 4-4A-203)**

1. Some person will always be identified as the sender of a payment order. Acceptance of the order by the receiving bank is based on a belief by the bank that the order was authorized by the person identified as the sender. If the receiving bank is the beneficiary's bank acceptance means that the receiving bank is obliged to pay the beneficiary. If the receiving bank is not the beneficiary's bank, acceptance means that the receiving bank has executed the sender's order and is obliged to pay the bank that accepted the order issued in execution of the sender's order. In either case the receiving bank may suffer a loss unless it is entitled to enforce payment of the payment order that it accepted. If the person identified as the sender of the order refuses to pay on the ground that the order was not authorized by that person, what are the rights of the receiving bank? In the absence of a statute or agreement that specifically addresses

the issue, the question usually will be resolved by the law of agency. In some cases, the law of agency works well. For example, suppose the receiving bank executes a payment order given by means of a letter apparently written by a corporation that is a customer of the bank and apparently signed by an officer of the corporation. If the receiving bank acts solely on the basis of the letter, the corporation is not bound as the sender of the payment order unless the signature was that of the officer and the officer was authorized to act for the corporation in the issuance of payment orders, or some other agency doctrine such as apparent authority or estoppel causes the corporation to be bound. Estoppel can be illustrated by the following example. Suppose P is aware that A, who is unauthorized to act for P, has fraudulently misrepresented to T that A is authorized to act for P. T believes A and is about to rely on the misrepresenta-

tion. If P does not notify T of the true facts although P could easily do so, P may be estopped from denying A's lack of authority. A similar result could follow if the failure to notify T is the result of negligence rather than a deliberate decision. Restatement, Second, Agency § 8B. Other equitable principles such as subrogation or restitution might also allow a receiving bank to recover with respect to an unauthorized payment order that it accepted. In *Gatolil (U.S.A.), Inc. v. Forest Hill State Bank*, 1 U.C.C.Rep.Serv.2d 171 (D.Md.1986), a joint venturer not authorized to order payments from the account of the joint venture, ordered a funds transfer from the account. The transfer paid a bona fide debt of the joint venture. Although the transfer was unauthorized the court refused to require recredit of the account because the joint venture suffered no loss. The result can be rationalized on the basis of subrogation of the receiving bank to the right of the beneficiary of the funds transfer to receive the payment from the joint venture.

But in most cases these legal principles give the receiving bank very little protection in the case of an authorized payment order. Cases like those just discussed are not typical of the way that most payment orders are transmitted and accepted, and such cases are likely to become even less common. Given the large amount of the typical payment order, a prudent receiving bank will be unwilling to accept a payment order unless it has assurance that the order is what it purports to be. This assurance is normally provided by security procedures described in Section 4A-201 (A.C.A. § 4-4A-201).

In a very large percentage of cases covered by Article 4A (A.C.A. § 4-4A-101 et seq.), transmission of the payment order is made electronically. The receiving bank may be required to act on the basis of a message that appears on a computer screen. Common law concepts of authority of agent to bind principal are not helpful. There is no way of determining the identity or the authority of the person who caused the message to be sent. The receiving bank is not relying on the authority of any particular person to act for the purported sender. The case is not comparable to payment of a check by the drawee bank on the basis of a signature that is forged. Rather, the receiving bank relies on a

security procedure pursuant to which the authenticity of the message can be "tested" by various devices which are designed to provide certainty that the message is that of the sender identified in the payment order. In the wire transfer business the concept of "authorized" is different from that found in agency law. In that business a payment order is treated as the order of the person in whose name it is issued if it is properly tested pursuant to a security procedure and the order passes the test.

Section 4A-202 (A.C.A. § 4-4A-202) reflects the reality of the wire transfer business. A person in whose name a payment order is issued is considered to be the sender of the order if the order is "authorized" as stated in subsection (a) (A.C.A. § 4-4A-202(a)) or if the order is "verified" pursuant to a security procedure in compliance with subsection (b) (A.C.A. § 4-4A-202(b)). If subsection (b) (A.C.A. § 4-4A-202(b)) does not apply, the question of whether the customer is responsible for the order is determined by the law of agency. The issue is one of actual or apparent authority of the person who caused the order to be issued in the name of the customer. In some cases the law of agency might allow the customer to be bound by an unauthorized order if conduct of the customer can be used to find an estoppel against the customer to deny that the order was unauthorized. If the customer is bound by the order under any of these agency doctrines, subsection (a) (A.C.A. § 4-4A-202(a)) treats the order as authorized and thus the customer is deemed to be the sender of the order. In most cases, however, subsection (b) (A.C.A. § 4-4A-202(b)) will apply. In that event there is no need to make an agency law analysis to determine authority. Under Section 4A-202 (A.C.A. § 4-4A-202), the issue of liability of the purported sender of the payment order will be determined by agency law only if the receiving bank did not comply with subsection (b) (A.C.A. § 4-4A-202(b)).

2. The scope of Section 4A-202 (A.C.A. § 4-4A-202) can be illustrated by the following cases. *Case # 1.* A payment order purporting to be that of Customer is received by Receiving Bank but the order was fraudulently transmitted by a person who had no authority to act for Customer. *Case # 2.* An authentic payment order



was sent by Customer, but before the order was received by Receiving Bank, the order was fraudulently altered by an unauthorized person to change the beneficiary. *Case # 3*. An authentic payment order was received by Receiving Bank, but before the order was executed by Receiving Bank a person who had no authority to act for Customer fraudulently sent a communication purporting to amend the order by changing the beneficiary. In each case Receiving Bank acted on the fraudulent communication by accepting the payment order. These cases are all essentially similar and they are treated identically by Section 4A-202 (A.C.A. § 4-4A-202). In each case Receiving Bank acted on a communication that it thought was authorized by Customer when in fact the communication was fraudulent. No distinction is made between *Case # 1* in which Customer took no part at all in the transaction and *Case # 2* and *Case # 3* in which an authentic order was fraudulently altered or amended by an unauthorized person. If subsection (b) (A.C.A. § 4-4A-202(b)) does not apply, each case is governed by subsection (a) (A.C.A. § 4-4A-202(a)). If there are no additional facts on which an estoppel might be found, Customer is not responsible in *Case # 1* for the fraudulently issued payment order, in *Case # 2* for the fraudulent alteration or in *Case # 3* for the fraudulent amendment. Thus, in each case Customer is not liable to pay the order and Receiving Bank takes the loss. The only remedy of Receiving Bank is to seek recovery from the person who received payment as beneficiary of the fraudulent order. If there was verification in compliance with subsection (b) (A.C.A. § 4-4A-202(b)), Customer will take the loss unless Section 4A-203 (A.C.A. § 4-4A-203) applies.

3. Subsection (b) of Section 4A-202 (A.C.A. § 4-4A-202(b)) is based on the assumption that losses due to fraudulent payment orders can best be avoided by the use of commercially reasonable security procedures, and that the use of such procedures should be encouraged. The subsection is designed to protect both the customer and the receiving bank. A receiving bank needs to be able to rely on objective criteria to determine whether it can safely act on a payment order. Employees of the bank can be trained to "test" a payment order according to the various

steps specified in the security procedure. The bank is responsible for the acts of these employees. Subsection (b)(ii) (A.C.A. § 4-4A-202(b)(ii)) requires the bank to prove that it accepted the payment order in good faith and "in compliance with the security procedure." If the fraud was not detected because the bank's employee did not perform the acts required by the security procedure, the bank has not complied. Subsection (b)(ii) (A.C.A. § 4-4A-202(b)(ii)) also requires the bank to prove that it complied with any agreement or instruction that restricts acceptance of payment orders issued in the name of the customer. A customer may want to protect itself by imposing limitations on acceptance of payment orders by the bank. For example, the customer may prohibit the bank from accepting a payment order that is not payable from an authorized account, that exceeds the credit balance in specified accounts of the customer or that exceeds some other amount. Another limitation may relate to the beneficiary. The customer may provide the bank with a list of authorized beneficiaries and prohibit acceptance of any payment order to a beneficiary not appearing on the list. Such limitations may be incorporated into the security procedure itself or they may be covered by a separate agreement or instruction. In either case, the bank must comply with the limitations if the conditions stated in subsection (b) (A.C.A. § 4-4A-202(b)) are met. Normally limitations on acceptance would be incorporated into an agreement between the customer and the receiving bank, but in some cases the instruction might be unilaterally given by the customer. If standing instructions or an agreement state limitations on the ability of the receiving bank to act, provision must be made for later modification of the limitations. Normally this would be done by an agreement that specifies particular procedures to be followed. Thus, subsection (b) (A.C.A. § 4-4A-202(b)) states that the receiving bank is not required to follow an instruction that violates a written agreement. The receiving bank is not bound by an instruction unless it has adequate notice of it. Subsections (25), (26), and (27) of Section 1-201 (A.C.A. § 4-1-201(25), (26), and (27)) apply.

Subsection (b)(i) (A.C.A. § 4-4A-202(b)(i)) assures that the interests of the customer will be protected by providing an

incentive to a bank to make available to the customer a security procedure that is commercially reasonable. If a commercially reasonable security procedure is not made available to the customer, subsection (b) (A.C.A. § 4-4A-202(b)) does not apply. The result is that subsection (a) (A.C.A. § 4-4A-202(a)) applies and the bank acts at its peril in accepting a payment order that may be unauthorized. Prudent banking practice may require that security procedures be utilized in virtually all cases except for those in which personal contact between the customer and the bank eliminates the possibility of an unauthorized order. The burden of making available commercially reasonable security procedures is imposed on receiving banks because they generally determine what security procedures can be used and are in the best position to evaluate the efficacy of procedures offered to customers to combat fraud. The burden on the customer is to supervise its employees to assure compliance with the security procedure and to safeguard confidential security information and access to transmitting facilities so that the security procedure cannot be breached.

4. The principal issue that is likely to arise in litigation involving subsection (b) (A.C.A. § 4-4A-202(b)) is whether the security procedure in effect when a fraudulent payment order was accepted was commercially reasonable. The concept of what is commercially reasonable in a given case is flexible. Verification entails labor and equipment costs that can vary greatly depending upon the degree of security that is sought. A customer that transmits very large numbers of payment orders in very large amounts may desire and may reasonably expect to be provided with state-of-the-art procedures that provide maximum security. But the expense involved may make use of a state-of-the-art procedure infeasible for a customer that normally transmits payment orders infrequently or in relatively low amounts. Another variable is the type of receiving bank. It is reasonable to require large money center banks to make available state-of-the-art security procedures. On the other hand, the same requirement may not be reasonable for a small country bank. A receiving bank might have several security procedures that are designed to meet the varying needs of different cus-

tomers. The type of payment order is another variable. For example, in a wholesale wire transfer, each payment order is normally transmitted electronically and individually. A testing procedure will be individually applied to each payment order. In funds transfers to be made by means of an automated clearing house many payment orders are incorporated into an electronic device such as a magnetic tape that is physically delivered. Testing of the individual payment orders is not feasible. Thus, a different kind of security procedure must be adopted to take into account the different mode of transmission.

The issue of whether a particular security procedure is commercially reasonable is a question of law. Whether the receiving bank complied with the procedure is a question of fact. It is appropriate to make the finding concerning commercial reasonability a matter of law because security procedures are likely to be standardized in the banking industry and a question of law standard leads to more predictability concerning the level of security that a bank must offer to its customers. The purpose of subsection (b) (A.C.A. § 4-4A-202(b)) is to encourage banks to institute reasonable safeguards against fraud but not to make them insurers against fraud. A security procedure is not commercially unreasonable simply because another procedure might have been better or because the judge deciding the question would have opted for a more stringent procedure. The standard is not whether the security procedure is the best available. Rather it is whether the procedure is reasonable for the particular customer and the particular bank, which is a lower standard. On the other hand, a security procedure that fails to meet prevailing standards of good banking practice applicable to the particular bank should not be held to be commercially reasonable. Subsection (c) (A.C.A. § 4-4A-202(c)) states factors to be considered by the judge in making the determination of commercial reasonableness. Sometimes an informed customer refuses a security procedure that is commercially reasonable and suitable for that customer and insists on using a higher-risk procedure because it is more convenient or cheaper. In that case, under the last sentence of subsection (c) (A.C.A. § 4-4A-202(c)), the



customer has voluntarily assumed the risk of failure of the procedure and cannot shift the loss to the bank. But this result follows only if the customer expressly agrees in writing to assume that risk. It is implicit in the last sentence of subsection (c) (A.C.A. § 4-4A-202(c)) that a bank that accedes to the wishes of its customer in this regard is not acting in bad faith by so doing so long as the customer is made aware of the risk. In all cases, however, a receiving bank cannot get the benefit of subsection (b) (A.C.A. § 4-4A-202(b)) unless it has made available to the customer a security procedure that is commercially reasonable and suitable for use by that customer. In most cases, the mutual interest of bank and customer to protect against fraud should lead to agreement to a security procedure which is commercially reasonable.

5. The effect of Section 4A-202(b) (A.C.A. § 4-4A-202(b)) is to place the risk of loss on the customer if an unauthorized payment order is accepted by the receiving bank after verification by the bank in compliance with a commercially reasonable security procedure. An exception to this result is provided by Section 4A-203(a)(2) (A.C.A. § 4-4A-203(a)(2)). The customer may avoid the loss resulting from such a payment order if the customer can prove that the fraud was not committed by a person described in that subsection. Breach of a commercially reasonable security procedure requires that the person committing the fraud have knowledge of how the procedure works and knowledge of codes, identifying devices, and the like. That person may also need access to transmitting facilities through an access device or other software in order to breach the security procedure. This confidential information must be obtained either from a source controlled by the customer or from a source controlled by the receiving bank. If the customer can prove that the person committing the fraud did not obtain the confidential information from an agent or former agent of the customer or from a source controlled by the customer, the loss is shifted to the bank. "Prove" is defined in Section 4A-105(a)(7) (A.C.A. § 4-4A-105(a)(7)). Because of bank regulation requirements, in this kind of case

there will always be a criminal investigation as well as an internal investigation of the bank to determine the probable explanation for the breach of security. Because a funds transfer fraud usually will involve a very large amount of money, both the criminal investigation and the internal investigation are likely to be thorough. In some cases there may be an investigation by bank examiners as well. Frequently, these investigations will develop evidence of who is at fault and the cause of the loss. The customer will have access to evidence developed in these investigations and that evidence can be used by the customer in meeting its burden of proof.

6. The effect of Section 4A-202(b) (A.C.A. § 4-4A-202(b)) may also be changed by an agreement meeting the requirements of Section 4A-203(a)(1) (A.C.A. § 4-4A-203(a)(1)). Some customers may be unwilling to take all or part of the risk of loss with respect to unauthorized payment orders even if all of the requirements of Section 4A-202(b) (A.C.A. § 4-4A-202(b)) are met. By virtue of Section 4A-203(a)(1) (A.C.A. § 4-4A-203(a)(1)), a receiving bank may assume all of the risk of loss with respect to unauthorized payment orders or the customer and bank may agree that losses from unauthorized payment orders are to be divided as provided in the agreement.

7. In a large majority of cases the sender of a payment order is a bank. In many cases in which there is a bank sender, both the sender and the receiving bank will be members of a funds transfer system over which the payment order is transmitted. Since Section 4A-202(f) (A.C.A. § 4-4A-202(f)) does not prohibit a funds transfer system rule from varying rights and obligations under Section 4A-202 (A.C.A. § 4-4A-202), a rule of the funds transfer system can determine how loss due to an unauthorized payment order from a participating bank to another participating bank is to be allocated. A funds transfer system rule, however, cannot change the rights of a customer that is not a participating bank. § 4A-501(b) (A.C.A. § 4-4A-501(b)). Section 4A-202(f) (A.C.A. § 4-4A-202(f)) also prevents variation by agreement except to the extent stated.

**Comment to § 4A-204 (A.C.A. § 4-4A-204)**

1. With respect to unauthorized payment orders, in a very large percentage of cases a commercially reasonable security procedure will be in effect. Section 4A-204 (A.C.A. § 4-4A-204) applies only to cases in which (i) no commercially reasonable security procedure is in effect, (ii) the bank did not comply with a commercially reasonable security procedure that was in effect, (iii) the sender can prove, pursuant to Section 4A-203(a)(2) (A.C.A. § 4-4A-203(a)(2)), that the culprit did not obtain confidential security information controlled by the customer, or (iv) the bank, pursuant to Section 4A-203(a)(1) (A.C.A. § 4-4A-203(a)(1)) agreed to take all or part of the loss resulting from an unauthorized payment order. In each of these cases the bank takes the risk of loss with respect to an unauthorized payment order because the bank is not entitled to payment from the customer with respect to the order. The bank normally debits the customer's account or otherwise receives payment from the customer shortly after acceptance of the payment order. Subsection (a) of Section 4A-204 (A.C.A. § 4-4A-204(a)) states that the bank must recredit the account or refund payment to the extent the bank is not entitled to enforce payment.

2. Section 4A-204 (A.C.A. § 4-4A-204) is designed to encourage a customer to promptly notify the receiving bank that it has accepted an unauthorized payment order. Since cases of unauthorized payment orders will almost always involve fraud, the bank's remedy is normally to recover from the beneficiary of the unauthorized order if the beneficiary was party to the fraud. This remedy may not be worth very much and it may not make any difference whether or not the bank promptly learns about the fraud. But in some cases prompt notification may make it easier for the bank to recover some part

of its loss from the culprit. The customer will routinely be notified of the debit to its account with respect to an unauthorized order or will otherwise be notified of acceptance of the order. The customer has a duty to exercise ordinary care to determine that the order was unauthorized after it has received notification from the bank, and to advise the bank of the relevant facts within a reasonable time not exceeding 90 days after receipt of notification. Reasonable time is not defined and it may depend on the facts of the particular case. If a payment order for \$1,000,000 is wholly unauthorized, the customer should normally discover it in far less than 90 days. If a \$1,000,000 payment order was authorized but the name of the beneficiary was fraudulently changed, a much longer period may be necessary to discover the fraud. But in any event, if the customer delays more than 90 days the customer's duty has not been met. The only consequence of a failure of the customer to perform this duty is a loss of interest on the refund payable by the bank. A customer that acts promptly is entitled to interest from the time the customer's account was debited or the customer otherwise made payment. The rate of interest is stated in Section 4A-506 (A.C.A. § 4-4A-506). If the customer fails to perform the duty, no interest is recoverable for any part of the period before the bank learns that it accepted an unauthorized order. But the bank is not entitled to recovery from the customer based on negligence for failure to inform the bank. Loss of interest is in the nature of a penalty on the customer designed to provide an incentive for the customer to police its account. There is no intention to impose a duty on the customer that might result in shifting loss from the unauthorized order to the customer.

**Comment to § 4A-205 (A.C.A. § 4-4A-205)**

1. This section (A.C.A. § 4-4A-205) concerns error in the content or in the transmission of payment orders. It deals with three kinds of error. *Case # 1.* The order identifies a beneficiary not intended by the sender. For example, Sender intends

to wire funds to a beneficiary identified only by an account number. The wrong account number is stated in the order. *Case # 2.* The error is in the amount of the order. For example, Sender intends to wire \$1,000 to Beneficiary. Through error,



the payment order instructs payment of \$1,000,000. *Case # 3.* A payment order is sent to the receiving bank and then, by mistake, the same payment order is sent to the receiving bank again. In *Case # 3*, the receiving bank may have no way of knowing whether the second order is a duplicate of the first or is another order. Similarly, in *Case # 1* and *Case # 2*, the receiving bank may have no way of knowing that the error exists. In each case, if this section does not apply and the funds transfer is completed, Sender is obliged to pay the order. Section 4A-402 (A.C.A. § 4-4A-402). Sender's remedy, based on payment by mistake, is to recover from the beneficiary that received payment.

Sometimes, however, transmission of payment orders of the sender to the receiving bank is made pursuant to a security procedure designed to detect one or more of the errors described above. Since "security procedure" is defined by Section 4A-201 (A.C.A. § 4-4A-201) as "a procedure established by agreement of a customer and a receiving bank for the purpose of ... detecting error..." Section 4A-205 (A.C.A. § 4-4A-205) does not apply if the receiving bank and the customer did not agree to the establishment of a procedure for detecting error. A security procedure may be designed to detect an account number that is not one to which Sender normally makes payment. In that case, the security procedure may require a special verification that payment to the stated account number was intended. In the case of dollar amounts, the security procedure may require different codes for different dollar amounts. If a \$1,000,000 payment order contains a code that is inappropriate for that amount, the error in amount should be detected. In the case of duplicate orders, the security procedure may require that each payment order be identified by a number or code that applies to no other order. If the number or code of each payment order received is registered in a computer base, the receiving bank can quickly identify a duplicate order. The three cases covered by this section are essentially similar. In each, if the error is not detected, some beneficiary will receive funds that the beneficiary was not intended to receive. If this section applies, the risk of loss with respect to the error of the sender is shifted to the bank which has the burden of recovering the

funds from the beneficiary. The risk of loss is shifted to the bank only if the sender proves that the error would have been detected if there had been compliance with the procedure and that the sender (or an agent under Section 4A-206 (A.C.A. § 4-4A-206)) complied. In the case of a duplicate order or a wrong beneficiary, the sender doesn't have to pay the order. In the case of an overpayment, the sender does not have to pay the order to the extent of the overpayment. If subsection (a)(1) (A.C.A. § 4-4A-205(a)(1)) applies, the position of the receiving bank is comparable to that of a receiving bank that erroneously executes a payment order as stated in Section 4A-303 (A.C.A. § 4-4A-303). However, failure of the sender to timely report the error is covered by Section 4A-205(b) (A.C.A. § 4-4A-205(b)) rather than by Section 4A-304 (A.C.A. § 4-4A-304) which applies only to erroneous execution under Section 4A-303 (A.C.A. § 4-4A-303). A receiving bank to which the risk of loss is shifted by subsection (a)(1) or (2) (A.C.A. § 4-4A-205(a)(1) or (2)) is entitled to recover the amount erroneously paid to the beneficiary to the extent allowed by the law of mistake and restitution. Rights of the receiving bank against the beneficiary are similar to those of a receiving bank that erroneously executes a payment order as stated in Section 4A-303 (A.C.A. § 4-4A-303). Those rights are discussed in Comment 2 to Section 4A-303 (A.C.A. § 4-4A-303).

2. A security procedure established for the purpose of detecting error is not effective unless both sender and receiving bank comply with the procedure. Thus, the bank undertakes a duty of complying with the procedure for the benefit of the sender. This duty is recognized in subsection (a)(1) (A.C.A. § 4-4A-205(a)(1)). The loss with respect to the sender's error is shifted to the bank if the bank fails to comply with the procedure and the sender (or an agent under Section 4A-206 (A.C.A. § 4-4A-206)) does comply. Although the customer may have been negligent in transmitting the erroneous payment order, the loss is put on the bank on a last-clear-chance theory. A similar analysis applies to subsection (b) (A.C.A. § 4-4A-205(b)). If the loss with respect to an error is shifted to the receiving bank and the sender is notified by the bank that the erroneous payment order was accepted,

the sender has a duty to exercise ordinary care to discover the error and notify the bank of the relevant facts within a reasonable time not exceeding 90 days. If the bank can prove that the sender failed in this duty it is entitled to compensation for the loss incurred as a result of the failure. Whether the bank is entitled to recover from the sender depends upon whether the failure to give timely notice would have made any difference. If the bank could not have recovered from the beneficiary that received payment under the erroneous payment order even if timely

notice had been given, the sender's failure to notify did not cause any loss of the bank.

3. Section 4A-205 (A.C.A. § 4-4A-205) is subject to variation by agreement under Section 4A-501 (A.C.A. § 4-4A-501). Thus, if a receiving bank and its customer have agreed to a security procedure for detection of error, the liability of the receiving bank for failing to detect an error of the customer as provided in Section 4A-205 (A.C.A. § 4-4A-205) may be varied as provided in an agreement of the bank and the customer.

### Comment to § 4A-206 (A.C.A. § 4-4A-206)

1. A payment order may be issued to a receiving bank directly by delivery of a writing or electronic device or by an oral or electronic communication. If an agent of the sender is employed to transmit orders on behalf of the sender, the sender is bound by the order transmitted by the agent on the basis of agency law. Section 4A-206 (A.C.A. § 4-4A-206) is an application of that principle to cases in which a funds transfer or communication system acts as an intermediary in transmitting the sender's order to the receiving bank. The intermediary is deemed to be an agent of the sender for the purpose of transmitting payment orders and related messages for the sender. Section 4A-206 (A.C.A. § 4-4A-206) deals with error by the intermediary.

2. Transmission by an automated clearing house of an association of banks other than the Federal Reserve Banks is an example of a transaction covered by Section 4A-206 (A.C.A. § 4-4A-206). Suppose Originator orders Originator's Bank to cause a large number of payments to be made to many accounts in banks in various parts of the country. These payment orders are electronically transmitted to Originator's Bank and stored in an electronic device that is held by Originator's Bank. Or, transmission of the various payment orders is made by delivery to Originator's Bank of an electronic device containing the instruction to the bank. In either case the terms of the various payment orders by Originator are determined by the information contained in the electronic device. In order to execute the various orders, the information in the elec-

tronic device must be processed. For example, if some of the orders are for payments to accounts in Bank X and some to accounts in Bank Y, Originator's Bank will execute these orders of Originator's by issuing a series of payment orders to Bank X covering all payments to accounts in that bank, and by issuing a series of payment orders to Bank Y covering all payments to accounts in that bank. The orders to Bank X may be transmitted together by means of an electronic device, and those to Bank Y may be included in another electronic device. Typically, this processing is done by an automated clearing house acting for a group of banks including Originator's Bank. The automated clearing house is a funds transfer system. Section 4A-105(a)(5) (A.C.A. § 4-4A-105(a)(5)). Originator's Bank delivers Originator's electronic device or transmits the information contained in the device to the funds transfer system for processing into payment orders of Originator's Bank to the appropriate beneficiary's banks. The processing may result in an erroneous payment order. Originator's Bank, by use of Originator's electronic device, may have given information to the funds transfer system instructing payment of \$100,000 to an account in Bank X, but because of human error or an equipment malfunction the processing may have converted that instruction into an instruction to Bank X to make a payment of \$1,000,000. Under Section 4A-206 (A.C.A. § 4-4A-206), Originator's Bank issued a payment order for \$1,000,000 to Bank X when the erroneous information was sent to Bank X. Originator's Bank is responsible for the error of



the automated clearing house. The liability of the funds transfer system that made the error is not governed by Article 4A (A.C.A. § 4-4A-101 et seq.). It is left to the law of contracts, a funds transfer system rule, or other applicable law.

In the hypothetical case just discussed, if the automated clearing house is operated by a Federal Reserve Bank, the analysis is different. Section 4A-206 (A.C.A. § 4-4A-206) does not apply. Originator's Bank will execute Originator's payment orders by delivery or transmission of the electronic information to the Federal Re-

serve Bank for processing. The result is that Originator's Bank has issued payment orders to the Federal Reserve Bank which, in this case, is acting as an intermediary bank. When the Federal Reserve Bank has processed the information given to it by Originator's Bank it will issue payment orders to the various beneficiary's banks. If the processing results in an erroneous payment order, the Federal Reserve Bank has erroneously executed the payment order of Originator's Bank and the case is governed by Section 4A-303 (A.C.A. § 4-4A-303).

### Comment to § 4A-207 (A.C.A. § 4-4A-207)

1. Subsection (a) (A.C.A. § 4-4A-207(a)) deals with the problem of payment orders issued to the beneficiary's bank for payment to nonexistent or unidentifiable persons or accounts. Since it is not possible in that case for the funds transfer to be completed, subsection (a) (A.C.A. § 4-4A-207(a)) states that the order cannot be accepted. Under Section 4A-402(c) (A.C.A. § 4-4A-402(c)), a sender of a payment order is not obliged to pay its order unless the beneficiary's bank accepts a payment order instructing payment to the beneficiary of that sender's order. Thus, if the beneficiary of a funds transfer is nonexistent or unidentifiable, each sender in the funds transfer that has paid its payment order is entitled to get its money back.

2. Subsection (b) (A.C.A. § 4-4A-207(b)), which takes precedence over subsection (a) (A.C.A. § 4-4A-207(a)), deals with the problem of payment orders in which the description of the beneficiary does not allow identification of the beneficiary because the beneficiary is described by name and by an identifying number or an account number and the name and number refer to different persons. A very large percentage of payment orders issued to the beneficiary's bank by another bank are processed by automated means using machines capable of reading orders on standard formats that identify the beneficiary by an identifying number or the number of a bank account. The processing of the order by the beneficiary's bank and the crediting of the beneficiary's account are done by use of the identifying or bank account number without human reading of the payment order itself. The process is

comparable to that used in automated payment of checks. The standard format, however, may also allow the inclusion of the name of the beneficiary and other information which can be useful to the beneficiary's bank and the beneficiary but which plays no part in the process of payment. If the beneficiary's bank has both the account number and name of the beneficiary supplied by the originator of the funds transfer, it is possible for the beneficiary's bank to determine whether the name and number refer to the same person, but if a duty to make that determination is imposed on the beneficiary's bank the benefits of automated payment are lost. Manual handling of payment orders is both expensive and subject to human error. If payment orders can be handled on an automated basis there are substantial economies of operation and the possibility of clerical error is reduced. Subsection (b) (A.C.A. § 4-4A-207(b)) allows banks to utilize automated processing by allowing banks to act on the basis of the number without regard to the name if the bank does not know that the name and number refer to different persons. "Know" is defined in Section 1-201(25) (A.C.A. § 4-1-201(25)) to mean actual knowledge, and Section 1-201(27) (A.C.A. § 4-1-201(27)) states rules for determining when an organization has knowledge of information received by the organization. The time of payment is the pertinent time at which knowledge or lack of knowledge must be determined.

Although the clear trend is for beneficiary's banks to process payment orders by automated means, Section 4A-207

(A.C.A. § 4-4A-207) is not limited to cases in which processing is done by automated means. A bank that processes by semi-automated means or even manually may rely on number as stated in Section 4A-207 (A.C.A. § 4-4A-207).

In cases covered by subsection (b) (A.C.A. § 4-4A-207(b)) the erroneous identification would in virtually all cases be the identifying or bank account number. In the typical case the error is made by the originator of the funds transfer. The originator should know the name of the person who is to receive payment and can further identify that person by an address that would normally be known to the originator. It is not unlikely, however, that the originator may not be sure whether the identifying or account number refers to the person the originator intends to pay. Subsection (b)(1) (A.C.A. § 4-4A-207(b)(1)) deals with the typical case in which the beneficiary's bank pays on the basis of the account number and is not aware at the time of payment that the named beneficiary is not the holder of the account which was paid. In some cases the false number will be the result of error by the originator. In other cases fraud is involved. For example, Doe is the holder of shares in Mutual Fund. Thief, impersonating Doe, requests redemption of the shares and directs Mutual Fund to wire the redemption proceeds to Doe's account # 12345 in Beneficiary's Bank. Mutual Fund originates a funds transfer by issuing a payment order to Originator's Bank to make the payment to Doe's account # 12345 in Beneficiary's Bank. Originator's Bank executes the order by issuing a conforming payment order to Beneficiary's Bank which makes payment to account # 12345. That account is the account of Roe rather than Doe. Roe might be a person acting in concert with Thief or Roe might be an innocent third party. Assume that Roe is a gem merchant that agreed to sell gems to Thief who agreed to wire the purchase price to Roe's account in Beneficiary's Bank. Roe believed that the credit to Roe's account was a transfer of funds from Thief and released the gems to Thief in good faith in reliance on the payment. The case law is unclear on the responsibility of a beneficiary's bank in carrying out a payment order in which the identification of the beneficiary by name and number is conflicting. See Securities

Fund Services, Inc. v. American National Bank, 542 F.Supp. 323 (N.D. Ill. 1982) and Bradford Trust Co. v. Texas American Bank, 790 F.2d 407 (5th Cir. 1986). Section 4A-207 (A.C.A. § 4-4A-207) resolves the issue.

If Beneficiary's Bank did not know about the conflict between the name and number, subsection (b)(1) (A.C.A. § 4-4A-207(b)(1)) applies. Beneficiary's Bank has no duty to determine whether there is a conflict and it may rely on the number as the proper identification of the beneficiary of the order. When it accepts the order, it is entitled to payment from Originator's Bank. Section 4A-402(b) (A.C.A. § 4-4A-402(b)). On the other hand, if Beneficiary's Bank knew about the conflict between the name and number and nevertheless paid Roe, subsection (b)(2) (A.C.A. § 4-4A-207(b)(2)) applies. Under that provision, acceptance of the payment order of Originator's Bank did not occur because there is no beneficiary of that order. Since acceptance did not occur Originator's Bank is not obliged to pay Beneficiary's Bank. Section 4A-402(b) (A.C.A. § 4-4A-402(b)). Similarly, Mutual Fund is excused from its obligation to pay Originator's Bank. Section 4A-402(c) (A.C.A. § 4-4A-402(c)). Thus, Beneficiary's Bank takes the loss. Its only cause of action is against Thief. Roe is not obliged to return the payment to the beneficiary's bank because Roe received the payment in good faith and for value. Article 4A (A.C.A. § 4-4A-101 et seq.) makes irrelevant the issue of whether Mutual Fund was or was not negligent in issuing its payment order.

3. Normally, subsection (b)(1) (A.C.A. § 4-4A-207(b)(1)) will apply to the hypothetical case discussed in Comment 2. Beneficiary's Bank will pay on the basis of the number without knowledge of the conflict. In that case subsection (c) (A.C.A. § 4-4A-207(c)) places the loss on either Mutual Fund or Originator's Bank. It is not unfair to assign the loss to Mutual Fund because it is the person who dealt with the imposter and it supplied the wrong account number. It could have avoided the loss if it had not used an account number that it was not sure was that of Doe. Mutual Fund, however, may not have been aware of the risk involved in giving both name and number. Subsection (c) (A.C.A. § 4-4A-207(c)) is designed to protect the originator, Mutual Fund, in



this case. Under that subsection, the originator is responsible for the inconsistent description of the beneficiary if it had notice that the order might be paid by the beneficiary's bank on the basis of the number. If the originator is a bank, the originator always has that responsibility. The rationale is that any bank should know how payment orders are processed and paid. If the originator is not a bank, the originator's bank must prove that its customer, the originator, had notice. Notice can be proved by any admissible evidence, but the bank can always prove notice by providing the customer with a written statement of the required information and obtaining the customer's signature to the statement. That statement will then apply to any payment order accepted by the bank thereafter. The information need not be supplied more than once.

In the hypothetical case if Originator's Bank made the disclosure stated in the

last sentence of subsection (c)(2) (A.C.A. § 4-4A-207(c)(2)), Mutual Fund must pay Originator's Bank. Under subsection (d)(1) (A.C.A. § 4-4A-207(d)(1)), Mutual Fund has an action to recover from Roe if recovery from Roe is permitted by the law governing mistake and restitution. Under the assumed facts Roe should be entitled to keep the money as a person who took it in good faith and for value since it was taken as payment for the gems. In that case, Mutual Fund's only remedy is against Thief. If Roe was not acting in good faith, Roe has to return the money to Mutual Fund. If Originator's Bank does not prove that Mutual Fund had notice as stated in subsection (c)(2) (A.C.A. § 4-4A-207(c)(2)), Mutual Fund is not required to pay Originator's Bank. Thus, the risk of loss falls on Originator's Bank, whose remedy is against Roe or Thief as stated above. Subsection (d)(2) (A.C.A. § 4-4A-207(d)(2)).

#### **Comment to § 4A-208 (A.C.A. § 4-4A-208)**

1. This section (A.C.A. § 4-4A-208) addresses an issue similar to that addressed by Section 4A-207 (A.C.A. § 4-4A-207). Because of automation in the processing of payment orders, a payment order may identify the beneficiary's bank or an intermediary bank by an identifying number. The bank identified by number might or might not also be identified by name. The following two cases illustrate Section 4A-208(a) and (b) (A.C.A. § 4-4A-208(a) and (b)):

*Case # 1.* Originator's payment order to Originator's Bank identifies the beneficiary's bank as Bank A and instructs payment to Account # 12345 in that bank. Originator's Bank executes Originator's order by issuing a payment order to Intermediary Bank. In the payment order of Originator's Bank the beneficiary's bank is identified as Bank A but is also identified by number, # 67890. The identifying number refers to Bank B rather than Bank A. If processing by Intermediary Bank of the payment order of Originator's Bank is done by automated means, Intermediary Bank, in executing the order, will rely on the identifying number and will issue a payment order to Bank B rather than

Bank A. If there is an Account # 12345 in Bank B, the payment order of Intermediary Bank would normally be accepted and payment would be made to a person not intended by Originator. In this case, Section 4A-208(b)(1) (A.C.A. § 4-4A-208(b)(1)) puts the risk of loss on Originator's Bank. Intermediary Bank may rely on the number # 67890 as the proper identification of the beneficiary's bank. Intermediary Bank has properly executed the payment order of Originator's Bank. By using the wrong number to describe the beneficiary's bank, Originator's Bank has improperly executed Originator's payment order because the payment order of Originator's Bank provides for payment to the wrong beneficiary, the holder of Account # 12345 in Bank B rather than the holder of Account # 12345 in Bank A. Section 4A-302(a)(1) and Section 4A-303(c) (A.C.A. §§ 4-4A-302(a)(1) and 4-4A-303(c)). Originator's Bank is not entitled to payment from Originator but is required to pay Intermediary Bank. Section 4A-303(c) and Section 4A-402(c) (A.C.A. §§ 4-4A-303(c) and 4-4A-402(c)). Intermediary Bank is

also entitled to compensation for any loss and expenses resulting from the error by Originator's Bank.

If there is no Account # 12345 in Bank B, the result is that there is no beneficiary of the payment order issued by Originator's Bank and the funds transfer will not be completed. Originator's Bank is not entitled to payment from Originator and Intermediary Bank is not entitled to payment from Originator's Bank. Section 4A-402(c) (A.C.A. § 4-4A-402(c)). Since Originator's Bank improperly executed Originator's payment order it may be liable for damages under Section 4A-305 (A.C.A. § 4-4A-305). As stated above, Intermediary Bank is entitled to compensation for loss and expenses resulting from the error by Originator's Bank.

*Case # 2.* Suppose the same payment order by Originator to Originator's Bank as in Case # 1. In executing the payment order Originator's Bank issues a payment order to Intermediary Bank in which the beneficiary's bank is identified only by number, # 67890. That number does not refer to Bank A. Rather it identifies a person that is not a bank. If processing by Intermediary Bank of the payment order of Originator's Bank is done by automated means, Intermediary Bank will rely on the number # 67890 to identify the beneficiary's bank. Intermediary Bank has no duty to determine whether the number identifies a bank. The funds transfer cannot be completed in this case because no bank is identified as the beneficiary's bank. Subsection (a) (A.C.A. § 4-4A-208(a)) puts the risk of loss on Originator's Bank. Originator's Bank is not entitled to payment from Originator. Section 4A-402(c) (A.C.A. § 4-4A-402(c)). Originator's Bank has improperly executed Originator's payment order and may be liable for damages under Section 4A-305 (A.C.A. § 4-4A-305). Originator's Bank is obliged to compensate Intermediary Bank for loss and expenses resulting from the error by Originator's Bank.

Subsection (a) (A.C.A. § 4-4A-208(a)) also applies if # 67890 identifies a bank, but the bank is not Bank A.

Intermediary Bank may rely on the number as the proper identification of the beneficiary's bank. If the bank to which Intermediary Bank sends its payment order accepts the order, Intermediary Bank is entitled to payment from Originator's Bank, but Originator's Bank is not entitled to payment from Originator. The analysis is similar to that in Case # 1.

2. Subsection (b)(2) of Section 4A-208 (A.C.A. § 4-4A-208(b)(2)) addresses cases in which an erroneous identification of a beneficiary's bank or intermediary bank by name and number is made in a payment order of a sender that is not a bank. Suppose Originator issues a payment order to Originator's Bank that instructs that bank to use an intermediary bank identified as Bank A and by an identifying number, # 67890. The identifying number refers to Bank B. Originator intended to identify Bank A as intermediary bank. If Originator's Bank relied on the number and issued a payment order to Bank B the rights of Originator's Bank depend upon whether the proof of notice stated in subsection (b)(2) (A.C.A. § 4-4A-208(b)(2)) is made by Originator's Bank. If proof is made, Originator's Bank's rights are governed by subsection (b)(1) of Section 4A-208 (A.C.A. § 4-4A-208(b)(1)). Originator's Bank is not liable for breach of Section 4A-302(a)(1) (A.C.A. § 4-4A-302(a)(1)) and is entitled to compensation from Originator for any loss and expenses resulting from Originator's error. If notice is not proved, Originator's Bank may not rely on the number in executing Originator's payment order. Since Originator's Bank does not get the benefit of subsection (b)(1) (A.C.A. § 4-4A-208(b)(1)) in that case, Originator's Bank improperly executed Originator's payment order and is in breach of the obligation stated in Section 4A-302(a)(1) (A.C.A. § 4-4A-302(a)(1)). If notice is not given, Originator's Bank can rely on the name if it is not aware of the conflict in name and number. Subsection (b)(3) (A.C.A. § 4-4A-208(b)(3)).

3. Although the principal purpose of Section 4A-208 (A.C.A. § 4-4A-208) is to accommodate automated processing of payment orders, Section 4A-208 (A.C.A. § 4-4A-208) applies regardless of whether processing is done by automation, semiautomated means or manually.



**Comment to § 4A-209 (A.C.A. § 4-4A-209)**

1. This section (A.C.A. § 4-4A-209) treats the sender's payment order as a request by the sender to the receiving bank to execute or pay the order and that request can be accepted or rejected by the receiving bank. Section 4A-209 (A.C.A. § 4-4A-209) defines when acceptance occurs. Section 4A-210 (A.C.A. § 4-4A-210) covers rejection. Acceptance of the payment order imposes an obligation on the receiving bank to the sender if the receiving bank is not the beneficiary's bank, or to the beneficiary if the receiving bank is the beneficiary's bank. These obligations are stated in Section 4A-302 and Section 4A-404 (A.C.A. §§ 4-4A-302 and 4-4A-404).

2. Acceptance by a receiving bank other than the beneficiary's bank is defined in Section 4A-209(a) (A.C.A. § 4-4A-209(a)). That subsection states the only way that a bank other than the beneficiary's bank can accept a payment order. A payment order to a bank other than the beneficiary's bank is, in effect, a request that the receiving bank execute the sender's order by issuing a payment order to the beneficiary's bank or to an intermediary bank. Normally, acceptance occurs at the time of execution, but there is an exception stated in subsection (d) (A.C.A. § 4-4A-209(d)) and discussed in Comment 9. Execution occurs when the receiving bank "issues a payment order intended to carry out" the sender's order. Section 4A-301(a) (A.C.A. § 4-4A-301(a)). In some cases the payment order issued by the receiving bank may not conform to the sender's order. For example, the receiving bank might make a mistake in the amount of its order, or the order might be issued to the wrong beneficiary's bank or for the benefit of the wrong beneficiary. In all of these cases there is acceptance of the sender's order by the bank when the receiving bank issues its order intended to carry out the sender's order, even though the bank's payment order does not in fact carry out the instruction of the sender. Improper execution of the sender's order may lead to liability to the sender for damages or it may mean that the sender is not obliged to pay its payment order. These matters are covered in Section 4A-303, Section 4A-305, and Section 4A-402 (A.C.A. §§ 4-4A-303, 4-4A-305, and 4-4A-402).

3. A receiving bank has no duty to accept a payment order unless the bank makes an agreement, either before or after issuance of the payment order, to accept it, or acceptance is required by a funds transfer system rule. If the bank makes such an agreement it incurs a contractual obligation based on the agreement and may be held liable for breach of contract if a failure to execute violates the agreement. In many cases a bank will enter into an agreement with its customer to govern the rights and obligations of the parties with respect to payment orders issued to the bank by the customer or, in cases in which the sender is also a bank, there may be a funds transfer system rule that governs the obligations of a receiving bank with respect to payment orders transmitted over the system. Such agreements or rules can specify the circumstances under which a receiving bank is obliged to execute a payment order and can define the extent of liability of the receiving bank for breach of the agreement or rule. Section 4A-305(d) (A.C.A. § 4-4A-305(d)) states the liability for breach of an agreement to execute a payment order.

4. In the case of a payment order issued to the beneficiary's bank, acceptance is defined in Section 4A-209(b) (A.C.A. § 4-4A-209(b)). The function of a beneficiary's bank that receives a payment order is different from that of a receiving bank that receives a payment order for execution. In the typical case, the beneficiary's bank simply receives payment from the sender of the order, credits the account of the beneficiary and notifies the beneficiary of the credit. Acceptance by the beneficiary's bank does not create any obligation to the sender. Acceptance by the beneficiary's bank means that the bank is liable to the beneficiary for the amount of the order. Section 4A-404(a) (A.C.A. § 4-4A-404(a)). There are three ways in which the beneficiary's bank can accept a payment order which are described in the following comments.

5. Under Section 4A-209(b)(1) (A.C.A. § 4-4A-209(b)(1)), the beneficiary's bank can accept a payment order by paying the beneficiary. In the normal case of crediting an account of the beneficiary, payment

occurs when the beneficiary is given notice of the right to withdraw the credit, the credit is applied to a debt of the beneficiary, or "funds with respect to the order" are otherwise made available to the beneficiary. Section 4A-405(a) (A.C.A. § 4-4A-405(a)). The quoted phrase covers cases in which funds are made available to the beneficiary as a result of receipt of a payment order for the benefit of the beneficiary but the release of funds is not expressed as payment of the order. For example, the beneficiary's bank might express a release of funds equal to the amount of the order as a "loan" that will be automatically repaid when the beneficiary's bank receives payment by the sender of the order. If the release of funds is designated as a loan pursuant to a routine practice of the bank, the release is conditional payment of the order rather than a loan, particularly if normal incidents of a loan such as the signing of a loan agreement or note and the payment of interest are not present. Such a release of funds is payment to the beneficiary under Section 4A-405(a) (A.C.A. § 4-4A-405(a)). Under Section 4A-405(c) (A.C.A. § 4-4A-405(c)) the bank cannot recover the money from the beneficiary if the bank does not receive payment from the sender of the payment order that it accepted. Exceptions to this rule are stated in Section 4A-405(d) and (e) (A.C.A. § 4-4A-405(d) and (e)). The beneficiary's bank may also accept by notifying the beneficiary that the order has been received. "Notifies" is defined in Section 1-201(26) (A.C.A. § 4-1-201(26)). In some cases a beneficiary's bank will receive a payment order during the day but settlement of the sender's obligation to pay the order will not occur until the end of the day. If the beneficiary's bank wants to defer incurring liability to the beneficiary until the beneficiary's bank receives payment, it can do so. The beneficiary's bank incurs no liability to the beneficiary with respect to a payment order that it receives until it accepts the order. If the bank does not accept pursuant to subsection (b)(1) (A.C.A. § 4-4A-209(b)(1)), acceptance does not occur until the end of the day when the beneficiary's bank receives settlement. If the sender settles, the payment order will be accepted under subsection (b)(2) (A.C.A. § 4-4A-209(b)(2)) and the funds will be released to the beneficiary the next morn-

ing. If the sender doesn't settle, no acceptance occurs. In either case the beneficiary's bank suffers no loss.

6. In most cases the beneficiary's bank will receive a payment order from another bank. If the sender is a bank and the beneficiary's bank receives payment from the sender by final settlement through the Federal Reserve System or a funds transfer system (Section 4A-403(a)(1)) (A.C.A. § 4-4A-403(a)(1)) or, less commonly, through credit to an account of the beneficiary's bank with the sender or another bank (Section 4A-403(a)(2)) (A.C.A. § 4-4A-403(a)(2)), acceptance by the beneficiary's bank occurs at the time payment is made. Section 4A-209(b)(2) (A.C.A. § 4-4A-209(b)(2)). A minor exception to this rule is stated in Section 4A-209(c) (A.C.A. § 4-4A-209(c)). Section 4A-209(b)(2) (A.C.A. § 4-4A-209(b)(2)) results in automatic acceptance of payment orders issued to a beneficiary's bank by means of Fedwire because the Federal Reserve account of the beneficiary's bank is credited and final payment is made to that bank when the payment order is received.

Subsection (b)(2) (A.C.A. § 4-4A-209(b)(2)) would also apply to cases in which the beneficiary's bank mistakenly pays a person who is not the beneficiary of the payment order issued to the beneficiary's bank. For example, suppose the payment order provides for immediate payment to Account # 12345. The beneficiary's bank erroneously credits Account # 12346 and notifies the holder of that account of the credit. No acceptance occurs in this case under subsection (b)(1) (A.C.A. § 4-4A-209(b)(1)) because the beneficiary of the order has not been paid or notified. The holder of Account # 12345 is the beneficiary of the order issued to the beneficiary's bank. But acceptance will normally occur if the beneficiary's bank takes no other action, because the bank will normally receive settlement with respect to the payment order. At that time the bank has accepted because the sender paid its payment order. The bank is liable to pay the holder of Account # 12345. The bank has paid the holder of Account # 12346 by mistake, and has a right to recover the payment if the credit is withdrawn, to the extent provided in the law governing mistake and restitution.

7. Subsection (b)(3) (A.C.A. § 4-4A-209(b)(3)) covers cases of inaction by the



beneficiary's bank. It applies whether or not the sender is a bank and covers a case in which the sender and the beneficiary both have accounts with the receiving bank and payment will be made by debiting the account of the sender and crediting the account of the beneficiary. Subsection (b)(3) (A.C.A. § 4-4A-209(b)(3)) is similar to subsection (b)(2) (A.C.A. § 4-4A-209(b)(2)) in that it bases acceptance by the beneficiary's bank on payment by the sender. Payment by the sender is effected by a debit to the sender's account if the account balance is sufficient to cover the amount of the order. On the payment date (Section 4A-401) (A.C.A. § 4-4A-401) of the order the beneficiary's bank will normally credit the beneficiary's account and notify the beneficiary of receipt of the order if it is satisfied that the sender's account balance covers the order or is willing to give credit to the sender. In some cases, however, the bank may not be willing to give credit to the sender and it may not be possible for the bank to determine until the end of the day on the payment date whether there are sufficient good funds in the sender's account. There may be various transactions during the day involving funds going into and out of the account. Some of these transactions may occur late in the day or after the close of the banking day. To accommodate this situation, subsection (b)(3) (A.C.A. § 4-4A-209(b)(3)) provides that the status of the account is determined at the opening of the next funds transfer business day of the beneficiary's bank after the payment date of the order. If the sender's account balance is sufficient to cover the order, the beneficiary's bank has a source of payment and the result in almost all cases is that the bank accepts the order at that time if it did not previously accept under subsection (b)(1) (A.C.A. § 4-4A-209(b)(1)). In rare cases, a bank may want to avoid acceptance under subsection (b)(3) (A.C.A. § 4-4A-209(b)(3)) by rejecting the order as discussed in Comment 8.

8. Section 4A-209 (A.C.A. § 4-4A-209) is based on a general principle that a receiving bank is not obliged to accept a payment order unless it has agreed or is bound by a funds transfer system rule to do so. Thus, provision is made to allow the receiving bank to prevent acceptance of the order. This principle is consistently followed if the receiving bank is not the

beneficiary's bank. If the receiving bank is not the beneficiary's bank, acceptance is in the control of the receiving bank because it occurs only if the order is executed. But in the case of the beneficiary's bank acceptance can occur by passive receipt of payment under subsection (b)(2) or (3) (A.C.A. § 4-4A-209(b)(2) or (3)). In the case of a payment made by Fedwire acceptance cannot be prevented. In other cases the beneficiary's bank can prevent acceptance by giving notice of rejection to the sender before payment occurs under Section 4A-403(a)(1) or (2) (A.C.A. § 4-4A-403(a)(1) or (2)). A minor exception to the ability of the beneficiary's bank to reject is stated in Section 4A-502(c)(3) (A.C.A. § 4-4A-502(c)(3)).

Under subsection (b)(3) (A.C.A. § 4-4A-209(b)(3)) acceptance occurs at the opening of the next funds transfer business day of the beneficiary's bank following the payment date unless the bank rejected the order before that time or it rejects within one hour after that time. In some cases the sender and the beneficiary's bank may not be in the same time zone or the beginning of the business day of the sender and the funds transfer business day of the beneficiary's bank may not coincide. For example, the sender may be located in California and the beneficiary's bank in New York. Since in most cases notice of rejection would be communicated electronically or by telephone, it might not be feasible for the bank to give notice before one hour after the opening of the funds transfer business day in New York because at that hour, the sender's business day may not have started in California. For that reason, there are alternative deadlines stated in subsection (b)(3) (A.C.A. § 4-4A-209(b)(3)). In the case stated, the bank acts in time if it gives notice within one hour after the opening of the business day of the sender. But if the notice of rejection is received by the sender after the payment date, the bank is obliged to pay interest to the sender if the sender's account does not bear interest. In that case the bank had the use of funds of the sender that the sender could reasonably assume would be used to pay the beneficiary. The rate of interest is stated in Section 4A-506 (A.C.A. § 4-4A-506). If the sender receives notice on the day after the payment date the sender is entitled to one day's interest. If receipt of notice is

delayed for more than one day, the sender is entitled to interest for each additional day of delay.

9. Subsection (d) (A.C.A. § 4-4A-209(d)) applies only to a payment order by the originator of a funds transfer to the originator's bank and it refers to the following situation. On April 1, Originator instructs Bank A to make a payment on April 15 to the account of Beneficiary in Bank B. By mistake, on April 1, Bank A executes Originator's payment order by issuing a payment order to Bank B instructing immediate payment to Beneficiary. Bank B credited Beneficiary's account and immediately released the funds to Beneficiary. Under subsection (d) (A.C.A. § 4-4A-209(d)) no acceptance by Bank A occurred on April 1 when Originator's payment order was executed because acceptance cannot occur before the execution date which in this case would be April 15 or shortly before that date. Section 4A-301(b) (A.C.A. § 4-4A-301(b)). Under Section 4A-402(c) (A.C.A. § 4-4A-402(c)), Originator is not obliged to pay Bank A until the order is accepted and that can't occur until the execution date. But Bank A is required to pay Bank B when Bank B accepted Bank A's order on April 1. Unless Originator and Beneficiary are the same person, in almost all cases Originator is paying a debt owed to Beneficiary and early payment does not injure Originator because Originator does not have to pay Bank A until the execution date. Section 4A-402(c) (A.C.A. § 4-4A-402(c)). Bank A takes the interest loss. But suppose that on April 3, Originator concludes that no debt was owed to Beneficiary or that the debt was less than the amount of the payment order. Under Section 4A-211(b) (A.C.A. § 4-4A-211(b)) Originator can cancel its payment order if Bank A has not accepted. If early execution of Originator's

payment order is acceptance, Originator can suffer a loss because cancellation after acceptance is not possible without the consent of Bank A and Bank B. Section 4A-211(c) (A.C.A. § 4-4A-211(c)). If Originator has to pay Bank A, Originator would be required to seek recovery of the money from Beneficiary. Subsection (d) (A.C.A. § 4-4A-209(d)) prevents this result and puts the risk of loss on Bank A by providing that the early execution does not result in acceptance until the execution date. Since on April 3 Originator's order was not yet accepted, Originator can cancel it under Section 4A-211(b) (A.C.A. § 4-4A-211(b)). The result is that Bank A is not entitled to payment from Originator but is obliged to pay Bank B. Bank A has paid Beneficiary by mistake. If Originator's payment order is canceled, Bank A becomes the originator of an erroneous funds transfer to Beneficiary. Bank A has the burden of recovering payment from Beneficiary on the basis of a payment by mistake. If Beneficiary received the money in good faith in payment of a debt owed to Beneficiary by Originator, the law of mistake and restitution may allow Beneficiary to keep all or part of the money received. If Originator owed money to Beneficiary, Bank A has paid Originator's debt and, under the law of restitution, which applies pursuant to Section 1-103 (A.C.A. § 1-1-103), Bank A is subrogated to Beneficiary's rights against Originator on the debt.

If Bank A is the Beneficiary's bank and Bank A credited Beneficiary's account and released the funds to Beneficiary on April 1, the analysis is similar. If Originator's order is canceled, Bank A has paid Beneficiary by mistake. The right of Bank A to recover the payment from Beneficiary is similar to Bank A's rights in the preceding paragraph.

### Comment to § 4A-210 (A.C.A. § 4-4A-210)

1. With respect to payment orders issued to a receiving bank other than the beneficiary's bank, notice of rejection is not necessary to prevent acceptance of the order. Acceptance can occur only if the receiving bank executes the order. Section 4A-209(a) (A.C.A. § 4-4A-209(a)). But notice of rejection will routinely be given by such a bank in cases in which the bank

cannot or is not willing to execute the order for some reason. There are many reasons why a bank doesn't execute an order. The payment order may not clearly instruct the receiving bank because of some ambiguity in the order or an internal inconsistency. In some cases, the receiving bank may not be able to carry out the instruction because of equipment failure,



credit limitations on the receiving bank, or some other factor which makes proper execution of the order infeasible. In those cases notice of rejection is a means of informing the sender of the facts so that a corrected payment order can be transmitted or the sender can seek alternate means of completing the funds transfer. The other major reason for not executing an order is that the sender's account is insufficient to cover the order and the receiving bank is not willing to give credit to the sender. If the sender's account is sufficient to cover the order and the receiving bank chooses not to execute the order, notice of rejection is necessary to prevent liability to pay interest to the sender if the case falls within Section 4A-210(b) (A.C.A. § 4-4A-210(b)) which is discussed in Comment 3.

2. A payment order to the beneficiary's bank can be accepted by inaction of the bank. Section 4A-209(b)(2) and (3) (A.C.A. § 4-4A-209(b)(2) and (3)). To prevent acceptance under those provisions it is necessary for the receiving bank to send notice of rejection before acceptance occurs. Subsection (a) of Section 4A-210 (A.C.A. § 4-4A-210(a)) states the rule that rejection is accomplished by giving notice of rejection. This incorporates the definitions in Section 1-201(26) (A.C.A. § 4-1-201(26)). Rejection is effective when notice is given if it is given by a means that is reasonable in the circumstances. Otherwise, it is effective when the notice is received. The question of when rejection is effective is important only in the relatively few cases under subsection (b)(2) and (3) (A.C.A. § 4-4A-210(b)(2) and (3)) in which a notice of rejection is necessary to prevent acceptance. The question of whether a particular means is reasonable depends on the facts in a particular case. In a very large percentage of cases the sender and the receiving bank will be in direct electronic contact with each other and in those cases a notice of rejection can be transmitted instantaneously. Since time is of the essence in a large proportion of funds transfers, some quick means of transmission would usually be required, but this is not always the case. The parties may specify by agreement the means by which communication between the parties is to be made.

3. Subsection (b) (A.C.A. § 4-4A-210(b)) deals with cases in which a sender

does not learn until after the execution date that the sender's order has not been executed. It applies only to cases in which the receiving bank was assured of payment because the sender's account was sufficient to cover the order. Normally, the receiving bank will accept the sender's order if it is assured of payment, but there may be some cases in which the bank chooses to reject. Unless the receiving bank had obligated itself by agreement to accept, the failure to accept is not wrongful. There is no duty of the receiving bank to accept the payment order unless it is obliged to accept by express agreement. Section 4A-212 (A.C.A. § 4-4A-212). But even if the bank has not acted wrongfully, the receiving bank had the use of the sender's money that the sender could reasonably assume was to be the source of payment of the funds transfer. Until the sender learns that the order was not accepted the sender is denied the use of that money. Subsection (b) (A.C.A. § 4-4A-210(b)) obliges the receiving bank to pay interest to the sender as a restitution unless the sender receives notice of rejection on the execution date. The time of receipt of notice is determined pursuant to § 1-201(27) (A.C.A. § 4-1-201(27)). The rate of interest is stated in Section 4A-506 (A.C.A. § 4-4A-506). If the sender receives notice on the day after the execution date, the sender is entitled to one day's interest. If receipt of notice is delayed for more than one day, the sender is entitled to interest for each additional day of delay.

4. Subsection (d) (A.C.A. § 4-4A-210(d)) treats acceptance and rejection as mutually exclusive. If a payment order has been accepted, rejection of that order becomes impossible. If a payment order has been rejected it cannot be accepted later by the receiving bank. Once notice of rejection has been given, the sender may have acted on the notice by making the payment through other channels. If the receiving bank wants to act on a payment order that it has rejected it has to obtain the consent of the sender. In that case the consent of the sender would amount to the giving of a second payment order that substitutes for the rejected first order. If the receiving bank suspends payments (Section 4-104(1)(k)) (A.C.A. § 4-4-104(1)(k)), subsection (c) (A.C.A. § 4-4A-210(c)) provides that unaccepted payment orders are deemed rejected at the time

suspension of payments occurs. This prevents acceptance by passage of time under

Section 4A-209(b)(3) (A.C.A. § 4-4A-209(b)(3)).

### Comment to § 4A-211 (A.C.A. § 4-4A-211)

1. This section (A.C.A. § 4-4A-211) deals with cancellation and amendment of payment orders. It states the conditions under which cancellation or amendment is both effective and rightful. There is no concept of wrongful cancellation or amendment of a payment order. If the conditions stated in this section (A.C.A. § 4-4A-211) are not met the attempted cancellation or amendment is not effective. If the stated conditions are met the cancellation or amendment is effective and rightful. The sender of a payment order may want to withdraw or change the order because the sender has had a change of mind about the transaction or because the payment order was erroneously issued or for any other reason. One common situation is that of multiple transmission of the same order. The sender that mistakenly transmits the same order twice wants to correct the mistake by canceling the duplicate order. Or, a sender may have intended to order a payment of \$1,000,000 but mistakenly issued an order to pay \$10,000,000. In this case the sender might try to correct the mistake by canceling the order and issuing another order in the proper amount. Or, the mistake could be corrected by amending the order to change it to the proper amount. Whether the error is corrected by amendment or cancellation and reissue the net result is the same. This result is stated in the last sentence of subsection (e) (A.C.A. § 4-4A-211(e)).

2. Subsection (a) (A.C.A. § 4-4A-211(a)) allows a cancellation or amendment of a payment order to be communicated to the receiving bank "orally, electronically, or in writing." The quoted phrase is consistent with the language of Section 4A-103(a) (A.C.A. § 4-4A-103(a)) applicable to payment orders. Cancellations and amendments are normally subject to verification pursuant to security procedures to the same extent as payment orders. Subsection (a) (A.C.A. § 4-4A-211(a)) recognizes this fact by providing that in cases in which there is a security procedure in effect between the sender and the receiving bank the bank is not

bound by a communication canceling or amending an order unless verification has been made. This is necessary to protect the bank because under subsection (b) (A.C.A. § 4-4A-211(b)) a cancellation or amendment can be effective by unilateral action of the sender. Without verification the bank cannot be sure whether the communication was or was not effective to cancel or amend a previously verified payment order.

3. If the receiving bank has not yet accepted the order, there is no reason why the sender should not be able to cancel or amend the order unilaterally so long as the requirements of subsections (a) and (b) (A.C.A. § 4-4A-211(a) and (b)) are met. If the receiving bank has accepted the order, it is possible to cancel or amend but only if the requirements of subsection (c) (A.C.A. § 4-4A-211(c)) are met.

First consider the case of a receiving bank other than the beneficiary's bank. If the bank has not yet accepted the order, the sender can unilaterally cancel or amend. The communication amending or canceling the payment order must be received in time to allow the bank to act on it before the bank issues its payment order in execution of the sender's order. The time that the sender's communication is received is governed by Section 4A-106 (A.C.A. § 4-4A-106). If a payment order does not specify a delayed payment date or execution date, the order will normally be executed shortly after receipt. Thus, as a practical matter, the sender will have very little time in which to instruct cancellation or amendment before acceptance. In addition, a receiving bank will normally have cut-off times for receipt of such communications, and the receiving bank is not obliged to act on communications received after the cut-off hour. Cancellation by the sender after execution of the order by the receiving bank requires the agreement of the bank unless a funds transfer rule otherwise provides. Subsection (c) (A.C.A. § 4-4A-211(c)). Although execution of the sender's order by the receiving bank does not itself impose liability on the receiving bank (under Section



4A-402 (A.C.A. § 4-4A-402) no liability is incurred by the receiving bank to pay its order until it is accepted, it would commonly be the case that acceptance follows shortly after issuance. Thus, as a practical matter, a receiving bank that has executed a payment order will incur a liability to the next bank in the chain before it would be able to act on the cancellation request of its customer. It is unreasonable to impose on the receiving bank a risk of loss with respect to a cancellation request without the consent of the receiving bank.

The statute (A.C.A. § 4-4A-211) does not state how or when the agreement of the receiving bank must be obtained for cancellation after execution. The receiving bank's consent could be obtained at the time cancellation occurs or it could be based on a preexisting agreement. Or, a funds transfer system rule could provide that cancellation can be made unilaterally by the sender. By virtue of that rule any receiving bank covered by the rule is bound. Section 4A-501 (A.C.A. § 4-4A-501). If the receiving bank has already executed the sender's order, the bank would not consent to cancellation unless the bank to which the receiving bank has issued its payment order consents to cancellation of that order. It makes no sense to allow cancellation of a payment order unless all subsequent payment orders in the funds transfer that were issued because of the canceled payment order are also canceled. Under subsection (c)(1) (A.C.A. § 4-4A-211(c)(1)), if a receiving bank consents to cancellation of the payment order after it has executed, the cancellation is not effective unless the receiving bank also cancels the payment order issued by the bank.

4. With respect to a payment order issued to the beneficiary's bank, acceptance is particularly important because it creates liability to pay the beneficiary, it defines when the originator pays its obligation to the beneficiary, and it defines when any obligation for which the payment is made is discharged. Since acceptance affects the rights of the originator and the beneficiary it is not appropriate to allow the beneficiary's bank to agree to cancellation or amendment except in unusual cases. Except as provided in subsection (c)(2) (A.C.A. § 4-4A-211(c)(2)), cancellation or amendment after acceptance by the beneficiary's bank is not possible

unless all parties affected by the order agree. Under subsection (c)(2) (A.C.A. § 4-4A-211(c)(2)), cancellation or amendment is possible only in the four cases stated. The following examples illustrate subsection (c)(2) (A.C.A. § 4-4A-211(c)(2)):

*Case # 1.* Originator's Bank executed a payment order issued in the name of its customer as sender. The order was not authorized by the customer and was fraudulently issued. Beneficiary's Bank accepted the payment order issued by Originator's Bank. Under subsection (c)(2) (A.C.A. § 4-4A-211(c)(2)) Originator's Bank can cancel the order if Beneficiary's Bank consents. It doesn't make any difference whether the payment order that Originator's Bank accepted was or was not enforceable against the customer under Section 4A-202(b) (A.C.A. § 4-4A-202(b)). Verification under that provision is important in determining whether Originator's Bank or the customer has the risk of loss, but it has no relevance under Section 4A-211(c)(2) (A.C.A. § 4-4A-211(c)(2)). Whether or not verified, the payment order was not authorized by the customer. Cancellation of the payment order to Beneficiary's Bank causes the acceptance of Beneficiary's Bank to be nullified. Subsection (e) (A.C.A. § 4-4A-211(e)). Beneficiary's Bank is entitled to recover payment from the beneficiary to the extent allowed by the law of mistake and restitution. In this kind of case the beneficiary is usually a party to the fraud who has no right to receive or retain payment of the order.

*Case # 2.* Originator owed Beneficiary \$1,000,000 and ordered Bank A to pay that amount to the account of Beneficiary in Bank B. Bank A issued a complying order to Bank B, but by mistake issued a duplicate order as well. Bank B accepted both orders. Under subsection (c)(2)(i) (A.C.A. § 4-4A-211(c)(2)(i)) cancellation of the duplicate order could be made by Bank A with the consent of Bank B. Beneficiary has no right to receive or retain payment of the duplicate payment order if only \$1,000,000 was owed by Originator to Beneficiary. If Originator owed \$2,000,000 to Beneficiary, the law of restitution might allow

Beneficiary to retain the \$1,000,000 paid by Bank B on the duplicate order. In that case Bank B is entitled to reimbursement from Bank A under subsection (f) (A.C.A. § 4-4A-211(f)).

*Case # 3.* Originator owed \$1,000,000 to X. Intending to pay X, Originator ordered Bank A to pay \$1,000,000 to Y's account in Bank B. Bank A issued a complying payment order to Bank B which Bank B accepted by releasing the \$1,000,000 to Y. Under subsection (c)(2)(ii) (A.C.A. § 4-4A-211(c)(2)(ii)) Bank A can cancel its payment order to Bank B with the consent of Bank B if Y was not entitled to receive payment from Originator. Originator can also cancel its order to Bank A with Bank A's consent. Subsection (c)(1) (A.C.A. § 4-4A-211(c)(1)). Bank B may recover the \$1,000,000 from Y unless the law of mistake and restitution allows Y to retain some or all of the amount paid. If no debt was owed to Y, Bank B should have a right of recovery.

*Case # 4.* Originator owed Beneficiary \$10,000. By mistake Originator ordered Bank A to pay \$1,000,000 to the account of Beneficiary in Bank B. Bank A issued a complying order to Bank B which accepted by notifying Beneficiary of its right to withdraw \$1,000,000. Cancellation is permitted in this case under subsection (c)(2)(iii) (A.C.A. § 4-4A-211(c)(2)(iii)). If Bank B paid Beneficiary it is entitled to recover the payment except to the extent the law of mistake and restitution allows Beneficiary to retain payment. In this case Beneficiary might be entitled to retain \$10,000, the amount of the debt owed to Beneficiary. If Beneficiary may retain \$10,000, Bank B would be entitled to \$10,000 from Bank A pursuant to subsection (f) (A.C.A. § 4-4A-211(f)). In this case Originator also canceled its order. Thus Bank A would be entitled to \$10,000 from Originator pursuant to subsection (f) (A.C.A. § 4-4A-211(f)).

5. Unless constrained by a funds transfer system rule, a receiving bank may agree to cancellation or amendment of the payment order under subsection (c) (A.C.A. § 4-4A-211(c)) but is not required to do so regardless of the circumstances. If

the receiving bank has incurred liability as a result of its acceptance of the sender's order, there are substantial risks in agreeing to cancellation or amendment. This is particularly true for a beneficiary's bank. Cancellation or amendment after acceptance by the beneficiary's bank can be made only in the four cases stated and the beneficiary's bank may not have any way of knowing whether the requirements of subsection (c) (A.C.A. § 4-4A-211(c)) have been met or whether it will be able to recover payment from the beneficiary that received payment. Even with indemnity the beneficiary's bank may be reluctant to alienate its customer, the beneficiary, by denying the customer the funds. Subsection (c) (A.C.A. § 4-4A-211(c)) leaves the decision to the beneficiary's bank unless the consent of the beneficiary's bank is not required under a funds transfer system rule or other interbank agreement. If a receiving bank agrees to cancellation or amendment under subsection (c)(1) or (2) (A.C.A. § 4-4A-211(c)(1) or (2)), it is automatically entitled to indemnification from the sender under subsection (f) (A.C.A. § 4-4A-211(f)). The indemnification provision recognizes that a sender has no right to cancel a payment order after it is accepted by the receiving bank. If the receiving bank agrees to cancellation, it is doing so as an accommodation to the sender and it should not incur a risk of loss in doing so.

6. Acceptance by the receiving bank of a payment order issued by the sender is comparable to acceptance of an offer under the law of contracts. Under that law the death or legal incapacity of an offeror terminates the offer even though the offeree has no notice of the death or incapacity. Restatement Second, Contracts § 48. Comment a. to that section states that the "rule seems to be a relic of the obsolete view that a contract requires a 'meeting of minds,' and it is out of harmony with the modern doctrine that a manifestation of assent is effective without regard to actual mental assent." Subsection (g) (A.C.A. § 4-4A-211(g)), which reverses the Restatement rule in the case of a payment order, is similar to Section 4-405(1) (A.C.A. § 4-4-405(1)) which applies to checks. Subsection (g) (A.C.A. § 4-4A-211(g)) does not address the effect of the bankruptcy of the sender of a payment order before the order is accepted, but the



principle of subsection (g) (A.C.A. § 4-4A-211(g)) has been recognized in *Bank of Marin v. England*, 385 U.S. 99 (1966). Although Bankruptcy Code Section 542(c) may not have been drafted with wire transfers in mind, its language can be read to allow the receiving bank to charge the sender's account for the amount of the payment order if the receiving bank executed it in ignorance of the bankruptcy.

7. Subsection (d) (A.C.A. § 4-4A-211(d)) deals with stale payment orders. Payment orders normally are executed on the execution date or the day after. An order issued to the beneficiary's bank is normally accepted on the payment date or the day after. If a payment order is not accepted on its execution or payment date or shortly thereafter, it is probable that there was some problem with the terms of the order or the sender did not have sufficient funds or credit to cover the amount of the order. Delayed acceptance of such an order is normally not contemplated, but the order may not have been canceled

by the sender. Subsection (d) (A.C.A. § 4-4A-211(d)) provides for cancellation by operation of law to prevent an unexpected delayed acceptance.

8. A funds transfer system rule can govern rights and obligations between banks that are parties to payment orders transmitted over the system even if the rule conflicts with Article 4A (A.C.A. § 4-4A-101 et seq.). In some cases, however, a rule governing a transaction between two banks can affect a third party in an unacceptable way. Subsection (h) (A.C.A. § 4-4A-211(h)) deals with such a case. A funds transfer system rule cannot allow cancellation of a payment order accepted by the beneficiary's bank if the rule conflicts with subsection (c)(2) (A.C.A. § 4-4A-211(c)(2)). Because rights of the beneficiary and the originator are directly affected by acceptance, subsection (c)(2) (A.C.A. § 4-4A-211(c)(2)) severely limits cancellation. These limitations cannot be altered by funds transfer system rule.

#### **Comment to § 4A-212 (A.C.A. § 4-4A-212)**

With limited exceptions stated in this Article (Chapter) (A.C.A. § 4-4A-101 et seq.), the duties and obligations of receiving banks that carry out a funds transfer arise only as a result of acceptance of payment orders or of agreements made by receiving banks. Exceptions are stated in Section 4A-209(b)(3) and Section 4A-

210(b) (A.C.A. §§ 4-4A-209(b)(3) and 4-4A-210(b)). A receiving bank is not like a collecting bank under Article 4 (A.C.A. § 4-4-101 et seq.). No receiving bank, whether it be an originator's bank, an intermediary bank or a beneficiary's bank, is an agent for any other party in the funds transfer.

#### **Comment to § 4A-301 (A.C.A. § 4-4A-301)**

1. The terms "executed," "execution" and "execution date" are used only with respect to a payment order to a receiving bank other than the beneficiary's bank. The beneficiary's bank can accept the payment order that it receives, but it does not execute the order. Execution refers to the act of the receiving bank in issuing a payment order "intended to carry out" the payment order that the bank received. A receiving bank has executed an order even if the order issued by the bank does not carry out the order received by the bank. For example, the bank may have erroneously issued an order to the wrong beneficiary, or in the wrong amount or to the wrong beneficiary's bank. In each of these cases execution has occurred but the exe-

cution is erroneous. Erroneous execution is covered in Section 4A-303 (A.C.A. § 4-4A-303).

2. "Execution date" refers to the time a payment order should be executed rather than the day it is actually executed. Normally the sender will not specify an execution date, but most payment orders are meant to be executed immediately. Thus, the execution date is normally the day the order is received by the receiving bank. It is common for the sender to specify a "payment date" which is defined in Section 4A-401 (A.C.A. § 4-4A-401) as "the day on which the amount of the order is payable to the beneficiary by the beneficiary's bank." Except for automated clearing house transfers, if a funds transfer is

entirely within the United States and the payment is to be carried out electronically, the execution date is the payment date unless the order is received after the payment date. If the payment is to be carried out through an automated clearing house, execution may occur before the payment date. In an ACH transfer the beneficiary is usually paid one or two days after issue of the originator's payment order. The execution date is determined by the stated payment date and is a day before the payment date on which execution is reasonably necessary to allow payment on the payment date. A funds transfer system rule could also determine the execution date of orders received by the receiving bank if both the sender and the receiving bank are participants in the funds transfer system. The execution date can also be determined by the payment

order itself or by separate instructions of the sender or an agreement of the sender and the receiving bank. The second sentence of subsection (b) (A.C.A. § 4-4A-301(b)) must be read in the light of Section 4A-106 (A.C.A. § 4-4A-106) which states that if a payment order is received after the cut-off time of the receiving bank it may be treated by the bank as received at the opening of the next funds transfer business day.

3. Execution on the execution date is timely, but the order can be executed before or after the execution date. Section 4A-209(d) (A.C.A. § 4-4A-209(d)) and Section 4A-402(c) (A.C.A. § 4-4A-402(c)) state the consequences of early execution and Section 4A-305(a) (A.C.A. § 4-4A-305(a)) states the consequences of late execution.

#### **Comment to § 4A-302 (A.C.A. § 4-4A-302)**

1. In the absence of agreement, the receiving bank is not obliged to execute an order of the sender. Section 4A-212 (A.C.A. § 4-4A-212). Section 4A-302 (A.C.A. § 4-4A-302) states the manner in which the receiving bank may execute the sender's order if execution occurs. Subsection (a)(1) (A.C.A. § 4-4A-302(a)(1)) states the residual rule. The payment order issued by the receiving bank must comply with the sender's order and, unless some other rule is stated in the section, the receiving bank is obliged to follow any instruction of the sender concerning which funds transfer system is to be used, which intermediary banks are to be used, and what means of transmission is to be used. The instruction of the sender may be incorporated in the payment order itself or may be given separately. For example, there may be a master agreement between the sender and receiving bank containing instructions governing payment orders to be issued from time to time by the sender to the receiving bank. In most funds transfers, speed is a paramount consideration. A sender that wants assurance that the funds transfer will be expeditiously completed can specify the means to be used. The receiving bank can follow the instructions literally or it can use an equivalent means. For example, if the sender instructs the receiving bank to

transmit by telex, the receiving bank could use telephone instead. Subsection (c) (A.C.A. § 4-4A-302(c)). In most cases the sender will not specify a particular means but will use a general term such as "by wire" or "wire transfer" or "as soon as possible." These words signify that the sender wants a same-day transfer. In these cases the receiving bank is required to use a telephonic or electronic communication to transmit its order and is also required to instruct any intermediary bank to which it issues its order to transmit by similar means. Subsection (a)(2) (A.C.A. § 4-4A-302(a)(2)). In other cases, such as an automated clearing house transfer, a same-day transfer is not contemplated. Normally the sender's instruction or the context in which the payment order is received makes clear the type of funds transfer that is appropriate. If the sender states a payment date with respect to the payment order, the receiving bank is obliged to execute the order at a time and in a manner to meet the payment date if that is feasible. Subsection (a)(2) (A.C.A. § 4-4A-302(a)(2)). This provision would apply to many ACH transfers made to pay recurring debts of the sender. In other cases, involving relatively small amounts, time may not be an important factor and cost may be a more important element. Fast means, such as telephone or elec-



tronic transmission, are more expensive than slow means such as mailing. Subsection (c) (A.C.A. § 4-4A-302(c)) states that in the absence of instructions the receiving bank is given discretion to decide. It may issue its payment order by first class mail or by any means reasonable in the circumstances. Section 4A-305 (A.C.A. § 4-4A-305) states the liability of a receiving bank for breach of the obligations stated in Section 4A-302 (A.C.A. § 4-4A-302).

2. Subsection (b) (A.C.A. § 4-4A-302(b)) concerns the choice of intermediary banks to be used in completing the funds transfer, and the funds transfer system to be used. If the receiving bank is not instructed about the matter, it can issue an order directly to the beneficiary's bank or can issue an order to an intermediary bank. The receiving bank also has discretion concerning use of a funds transfer system. In some cases it may be reasonable to use either an automated clearing house system or a wire transfer system such as Fedwire or CHIPS. Normally, the receiving bank will follow the instruction of the sender in these matters, but in some cases it may be prudent for the bank not to follow instructions. The sender may have designated a funds transfer system to be used in carrying out the funds transfer, but it may not be feasible to use the designated system because of some impediment such as a computer breakdown which prevents prompt execution of the order. The receiving bank is permitted to use an alternate means of transmittal in a good faith effort to execute the order expeditiously. The same leeway is not given to the receiving bank if the sender designates an intermediary bank through which the funds transfer is to be routed. The sender's designation of that intermediary bank may mean that the beneficiary's bank is expecting to obtain a credit from that intermediary bank and may have relied on that anticipated credit. If the receiving bank uses another intermediary bank the expectations of the beneficiary's bank may not be realized. The receiving bank could choose to route the transfer to another intermediary bank and then to the designated intermediary bank if there were some reason such as a lack of a correspondent-bank relationship or a bilateral credit limitation, but the designated intermediary bank cannot be

circumvented. To do so violates the sender's instructions.

3. The normal rule, under subsection (a)(1) (A.C.A. § 4-4A-302(a)(1)), is that the receiving bank, in executing a payment order, is required to issue a payment order that complies as to amount with that of the sender's order. In most cases the receiving bank issues an order equal to the amount of the sender's order and makes a separate charge for services and expenses in executing the sender's order. In some cases, particularly if it is an intermediary bank that is executing an order, charges are collected by deducting them from the amount of the payment order issued by the executing bank. If that is done, the amount of the payment order accepted by the beneficiary's bank will be slightly less than the amount of the originator's payment order. For example, Originator, in order to pay an obligation of \$1,000,000 owed to Beneficiary, issues a payment order to Originator's Bank to pay \$1,000,000 to the account of Beneficiary in Beneficiary's Bank. Originator's Bank issues a payment order to Intermediary Bank for \$1,000,000 and debits Originator's account for \$1,000,010. The extra \$10 is the fee of Originator's Bank. Intermediary Bank executes the payment order of Originator's Bank by issuing a payment order to Beneficiary's Bank for \$999,990, but under § 4A-402(c) (A.C.A. § 4-4A-402(c)) is entitled to receive \$1,000,000 from Originator's Bank. The \$10 difference is the fee of Intermediary Bank. Beneficiary's Bank credits Beneficiary's account for \$999,990. When Beneficiary's Bank accepts the payment order of Intermediary Bank the result is a payment of \$999,990 from Originator to Beneficiary. Section 4A-406(a) (A.C.A. § 4-4A-406(a)). If that payment discharges the \$1,000,000 debt, the effect is that Beneficiary has paid the charges of Intermediary Bank and Originator has paid the charges of Originator's Bank. Subsection (d) of Section 4A-302 (A.C.A. § 4-4A-302(d)) allows Intermediary Bank to collect its charges by deducting them from the amount of the payment order, but only if instructed to do so by Originator's Bank. Originator's Bank is not authorized to give that instruction to Intermediary Bank unless Originator authorized the instruction. Thus, Originator can control how the charges of Originator's Bank and Inter-

mediary Bank are to be paid. Subsection (d) (A.C.A. § 4-4A-302(d)) does not apply to charges of Beneficiary's Bank to Beneficiary.

In the case discussed in the preceding paragraph the \$10 charge is trivial in relation to the amount of the payment and it may not be important to Beneficiary how the charge is paid. But it may be very important if the \$1,000,000 obligation represented the price of exercising a right such as an option favorable to Originator and unfavorable to Beneficiary. Benefi-

ciary might well argue that it was entitled to receive \$1,000,000. If the option was exercised shortly before its expiration date, the result could be loss of the option benefit because the required payment of \$1,000,000 was not made before the option expired. Section 4A-406(c) (A.C.A. § 4-4A-406(c)) allows Originator to preserve the option benefit. The amount received by Beneficiary is deemed to be \$1,000,000 unless Beneficiary demands the \$10 and Originator does not pay it.

### Comment to § 4A-303 (A.C.A. § 4-4A-303)

1. Section 4A-303 (A.C.A. § 4-4A-303) states the effect of erroneous execution of a payment order by the receiving bank. Under Section 4A-402(c) (A.C.A. § 4-4A-402(c)) the sender of a payment order is obliged to pay the amount of the order to the receiving bank if the bank executes the order, but the obligation to pay is excused if the beneficiary's bank does not accept a payment order instructing payment to the beneficiary of the sender's order. If erroneous execution of the sender's order causes the wrong beneficiary to be paid, the sender is not required to pay. If erroneous execution causes the wrong amount to be paid the sender is not obliged to pay the receiving bank an amount in excess of the amount of the sender's order. Section 4A-303 (A.C.A. § 4-4A-303) takes precedence over Section 4A-402(c) (A.C.A. § 4-4A-402(c)) and states the liability of the sender and the rights of the receiving bank in various cases of erroneous execution.

2. Subsections (a) and (b) (A.C.A. § 4-4A-303(a) and (b)) deal with cases in which the receiving bank executes by issuing a payment order in the wrong amount. If Originator ordered Originator's Bank to pay \$1,000,000 to the account of Beneficiary in Beneficiary's Bank, but Originator's Bank erroneously instructed Beneficiary's Bank to pay \$2,000,000 to Beneficiary's account, subsection (a) (A.C.A. § 4-4A-303(a)) applies. If Beneficiary's Bank accepts the order of Originator's Bank, Beneficiary's Bank is entitled to receive \$2,000,000 from Originator's Bank, but Originator's Bank is entitled to receive only \$1,000,000 from Originator. Originator's Bank is entitled

to recover the overpayment from Beneficiary to the extent allowed by the law governing mistake and restitution. Originator's Bank would normally have a right to recover the overpayment from Beneficiary, but in unusual cases the law of restitution might allow Beneficiary to keep all or part of the overpayment. For example, if Originator owed \$2,000,000 to Beneficiary and Beneficiary received the extra \$1,000,000 in good faith in discharge of the debt, Beneficiary may be allowed to keep it. In this case Originator's Bank has paid an obligation of Originator and under the law of restitution, which applies through Section 1-103 (A.C.A. § 4-1-103), Originator's Bank would be subrogated to Beneficiary's rights against Originator on the obligation paid by Originator's Bank.

If Originator's Bank erroneously executed Originator's order by instructing Beneficiary's Bank to pay less than \$1,000,000, subsection (b) (A.C.A. § 4-4A-303(b)) applies. If Originator's Bank corrects its error by issuing another payment order to Beneficiary's Bank that results in payment of \$1,000,000 to Beneficiary, Originator's Bank is entitled to payment of \$1,000,000 from Originator. If the mistake is not corrected, Originator's Bank is entitled to payment from Originator only in the amount of the order issued by Originator's Bank.

3. Subsection (a) (A.C.A. § 4-4A-303(a)) also applies to duplicate payment orders. Assume Originator's Bank properly executes Originator's \$1,000,000 payment order and then by mistake issues a second \$1,000,000 payment order in execution of Originator's order. If Beneficia-



ry's Bank accepts both orders issued by Originator's Bank, Beneficiary's Bank is entitled to receive \$2,000,000 from Originator's Bank but Originator's Bank is entitled to receive only \$1,000,000 from Originator. The remedy of Originator's Bank is the same as that of a receiving bank that executes by issuing an order in an amount greater than the sender's order. It may recover the overpayment from Beneficiary to the extent allowed by the law governing mistake and restitution and in a proper case as stated in Comment 2 may have subrogation rights if it is not entitled to recover from Beneficiary.

4. Suppose Originator instructs Ori-

ginator's Bank to pay \$1,000,000 to Account # 12345 in Beneficiary's Bank. Originator's Bank erroneously instructs Beneficiary's Bank to pay \$1,000,000 to Account # 12346 and Beneficiary's Bank accepted. Subsection (c) (A.C.A. § 4-4A-303(c)) covers this case. Originator is not obliged to pay its payment order, but Originator's Bank is required to pay \$1,000,000 to Beneficiary's Bank. The remedy of Originator's Bank is to recover \$1,000,000 from the holder of Account # 12346 that received payment by mistake. Recovery based on the law of mistake and restitution is described in Comment 2.

#### **Comment to § 4A-304 (A.C.A. § 4-4A-304)**

This section (A.C.A. § 4-4A-304) is identical in effect to Section 4A-204 (A.C.A. § 4-4A-204) which applies to unauthorized orders issued in the name of a

customer of the receiving bank. The rationale is stated in Comment 2 to Section 4A-204 (A.C.A. § 4-4A-204).

#### **Comment to § 4A-305 (A.C.A. § 4-4A-305)**

1. Subsection (a) (A.C.A. § 4-4A-305(a)) covers cases of delay in completion of a funds transfer resulting from an execution by a receiving bank in breach of Section 4A-302(a) (A.C.A. § 4-4A-302(a)). The receiving bank is obliged to pay interest on the amount of the order for the period of the delay. The rate of interest is stated in Section 4A-506 (A.C.A. § 4-4A-506). With respect to wire transfers (other than ACH transactions) within the United States, the expectation is that the funds transfer will be completed the same day. In those cases, the originator can reasonably expect that the originator's account will be debited on the same day as the beneficiary's account is credited. If the funds transfer is delayed, compensation can be paid either to the originator or to the beneficiary. The normal practice is to compensate the beneficiary's bank to allow that bank to compensate the beneficiary by back-valuing the payment by the number of days of delay. Thus, the beneficiary is in the same position that it would have been in if the funds transfer had been completed on the same day. Assume on Day 1, Originator's Bank issues its payment order to Intermediary Bank which is received on that day. Intermediary Bank does not execute that order

until Day 2 when it issues an order to Beneficiary's Bank which is accepted on that day. Intermediary Bank complies with subsection (a) (A.C.A. § 4-4A-305(a)) by paying one day's interest to Beneficiary's Bank for the account of Beneficiary.

2. Subsection (b) (A.C.A. § 4-4A-305(b)) applies to cases of breach of Section 4A-302 (A.C.A. § 4-4A-302) involving more than mere delay. In those cases the bank is liable for damages for improper execution but they are limited to compensation for interest losses and incidental expenses of the sender resulting from the breach, the expenses of the sender in the funds transfer and attorney's fees. This subsection (A.C.A. § 4-4A-305(b)) reflects the judgment that imposition of consequential damages on a bank for commission of an error is not justified.

The leading common law case on the subject of consequential damages is *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951 (7th Cir. 1982), in which Swiss Bank, an intermediary bank, failed to execute a payment order. Because the beneficiary did not receive timely payment the originator lost a valuable ship charter. The lower court awarded the originator \$2.1 million for lost profits even though the amount of the payment order was only

\$27,000. The Seventh Circuit reversed, in part on the basis of the common law rule of *Hadley v. Baxendale* that consequential damages may not be awarded unless the defendant is put on notice of the special circumstances giving rise to them. Swiss Bank may have known that the originator was paying the shipowner for the hire of a vessel but did not know that a favorable charter would be lost if the payment was delayed. "Electronic payments are not so unusual as to automatically place a bank on notice of extraordinary consequences if such a transfer goes awry. Swiss Bank did not have enough information to infer that if it lost a \$27,000 payment order it would face liability in excess of \$2 million." 673 F.2d at 956.

If *Evra* means that consequential damages can be imposed if the culpable bank has notice of particular circumstances giving rise to the damages, it does not provide an acceptable solution to the problem of bank liability for consequential damages. In the typical case transmission of the payment order is made electronically. Personnel of the receiving bank that process payment orders are not the appropriate people to evaluate the risk of liability for consequential damages in relation to the price charged for the wire transfer service. Even if notice is received by higher level management personnel who could make an appropriate decision whether the risk is justified by the price, liability based on notice would require evaluation of payment orders on an individual basis. This kind of evaluation is inconsistent with the high-speed, low-price, mechanical nature of the processing system that characterizes wire transfers. Moreover, in *Evra* the culpable bank was an intermediary bank with which the originator did not deal. Notice to the originator's bank would not bind the intermediary bank, and it seems impractical for the originator's bank to convey notice of this kind to intermediary banks in the funds transfer. The success of the wholesale wire transfer industry has largely been based on its ability to effect payment at low cost and great speed. Both of these essential aspects of the modern wire transfer system would be adversely affected by a rule that imposed on banks liability for consequential damages. A banking industry amicus brief in *Evra* stated: "Whether banks can continue to

make EFT services available on a widespread basis, by charging reasonable rates, depends on whether they can do so without incurring unlimited consequential risks. Certainly, no bank would handle for \$3.25 a transaction entailing potential liability in the millions of dollars."

As the court in *Evra* also noted, the originator of the funds transfer is in the best position to evaluate the risk that a funds transfer will not be made on time and to manage that risk by issuing a payment order in time to allow monitoring of the transaction. The originator, by asking the beneficiary, can quickly determine if the funds transfer has been completed. If the originator has sent the payment order at a time that allows a reasonable margin for correcting error, no loss is likely to result if the transaction is monitored. The other published cases on this issue reach the *Evra* result. *Central Coordinates, Inc. v. Morgan Guaranty Trust Co.*, 40 U.C.C.Rep.Serv. 1340 (N.Y.Sup.Ct. 1985), and *Gatoil (U.S.A.), Inc. v. Forest Hill State Bank*, 1 U.C.C.Rep.Serv.2d 171 (D.Md. 1986).

Subsection (c) (A.C.A. § 4-4A-305(c)) allows the measure of damages in subsection (b) (A.C.A. § 4-4A-305(b)) to be increased by an express written agreement of the receiving bank. An originator's bank might be willing to assume additional responsibilities and incur additional liability in exchange for a higher fee.

3. Subsection (d) (A.C.A. § 4-4A-305(d)) governs cases in which a receiving bank has obligated itself by express agreement to accept payment orders of a sender. In the absence of such an agreement there is no obligation by a receiving bank to accept a payment order. Section 4A-212 (A.C.A. § 4-4A-212). The measure of damages for breach of an agreement to accept a payment order is the same as that stated in subsection (b) (A.C.A. § 4-4A-305(b)). As in the case of subsection (b) (A.C.A. § 4-4A-305(b)), additional damages, including consequential damages, may be recovered to the extent stated in an express written agreement of the receiving bank.

4. Reasonable attorney's fees are recoverable only in cases in which damages are limited to statutory damages stated in subsections (a), (b) and (d) (A.C.A. § 4-4A-305(a), (b), and (d)). If additional damages are recoverable because provided for by an



express written agreement, attorney's fees are not recoverable. The rationale is that there is no need for statutory attorney's fees in the latter case, because the parties have agreed to a measure of damages which may or may not provide for attorney's fees.

**Comment to § 4A-401 (A.C.A. § 4-4A-401)**

"Payment date" refers to the day the beneficiary's bank is to pay the beneficiary. The payment date may be expressed in various ways so long as it indicates the day the beneficiary is to receive payment. For example, in ACH transfers the payment date is the equivalent of "settlement date" or "effective date." Payment date applies to the payment order issued to the

5. The effect of subsection (f) (A.C.A. § 4-4A-305(f)) is to prevent reduction of a receiving bank's liability under Section 4A-305 (A.C.A. § 4-4A-305).

**Comment to § 4A-402 (A.C.A. § 4-4A-402)**

1. Subsection (b) (A.C.A. § 4-4A-402(b)) states that the sender of a payment order to the beneficiary's bank must pay the order when the beneficiary's bank accepts the order. At that point the beneficiary's bank is obliged to pay the beneficiary. Section 4A-404(a) (A.C.A. § 4-4A-404(a)). The last clause of subsection (b) (A.C.A. § 4-4A-402(b)) covers a case of premature acceptance by the beneficiary's bank. In some funds transfers, notably automated clearing house transfers, a beneficiary's bank may receive a payment order with a payment date after the day the order is received. The beneficiary's bank might accept the order before the payment date by notifying the beneficiary of receipt of the order. Although the acceptance obliges the beneficiary's bank to pay the beneficiary, payment is not due until the payment date. The last clause of subsection (b) (A.C.A. § 4-4A-402(b)) is consistent with that result. The beneficiary's bank is also not entitled to payment from the sender until the payment date.

2. Assume that Originator instructs Bank A to order immediate payment to the account of Beneficiary in Bank B. Execution of Originator's payment ordered by Bank A is acceptance under Section 4A-209(a) (A.C.A. § 4-4A-209(a)). Under the second sentence of Section 4A-402(c) (A.C.A. § 4-4A-402(c)) the acceptance creates an obligation of Originator to pay Bank A the amount of the order.

beneficiary's bank, but a payment order issued to a receiving bank other than the beneficiary's bank may also state a date for payment to the beneficiary. In the latter case, the statement of a payment date is to instruct the receiving bank concerning time of execution of the sender's order. Section 4A-301(b) (A.C.A. § 4-4A-301(b)).

The last clause of that sentence deals with attempted funds transfers that are not completed. In that event the obligation of the sender to pay its payment order is excused. Originator makes payment to Beneficiary when Bank B, the beneficiary's bank, accepts a payment order for the benefit of Beneficiary. Section 4A-406(a) (A.C.A. § 4-4A-406(a)). If that acceptance by Bank B does not occur, the funds transfer has miscarried because Originator has not paid Beneficiary. Originator doesn't have to pay its payment order, and if it has already paid it is entitled to refund of the payment with interest. The rate of interest is stated in Section 4A-506 (A.C.A. § 4-4A-506). This "money-back guarantee" is an important protection of Originator. Originator is assured that it will not lose its money if something goes wrong in the transfer. For example, risk of loss resulting from payment to the wrong beneficiary is borne by some bank, not by Originator. The most likely reason for noncompletion is a failure to execute or an erroneous execution of a payment order by Bank A or an intermediary bank. Bank A may have issued its payment order to the wrong bank or it may have identified the wrong beneficiary in its order. The money-back guarantee is particularly important to Originator if noncompletion of the funds transfer is due to the fault of an intermediary bank rather than Bank A. In that case Bank A must refund payment to

Originator, and Bank A has the burden of obtaining refund from the intermediary bank that it paid.

Subsection (c) (A.C.A. § 4-4A-402(c)) can result in loss if an intermediary bank suspends payments. Suppose Originator instructs Bank A to pay to Beneficiary's account in Bank B and to use Bank C as an intermediary bank. Bank A executes Originator's order by issuing a payment order to Bank C. Bank A pays Bank C. Bank C fails to execute the order of Bank A and suspends payments. Under subsections (c) and (d) (A.C.A. § 4-4A-402(c) and (d)), Originator is not obliged to pay Bank A and is entitled to refund from Bank A of any payment that it may have made. Bank A is entitled to a refund from Bank C, but Bank C is insolvent. Subsection (e) (A.C.A. § 4-4A-402(e)) deals with this case. Bank A was required to issue its

payment order to Bank C because Bank C was designated as an intermediary bank by Originator. Section 4A-302(a)(1) (A.C.A. § 4-4A-302(a)(1)). In this case Originator takes the risk of insolvency of Bank C. Under subsection (e) (A.C.A. § 4-4A-402(e)), Bank A is entitled to payment from Originator and Originator is subrogated to the right of Bank A under subsection (d) (A.C.A. § 4-4A-402(d)) to refund of payment from Bank C.

3. A payment order is not like a negotiable instrument on which the drawer or maker has liability. Acceptance of the order by the receiving bank creates an obligation of the sender to pay the receiving bank the amount of the order. That is the extent of the sender's liability to the receiving bank and no other person has any rights against the sender with respect to the sender's order.

### Comment to § 4A-403 (A.C.A. § 4-4A-403)

1. This section (A.C.A. § 4-4A-403) defines when a sender pays the obligation stated in Section 4A-402 (A.C.A. § 4-4A-402). If a group of two or more banks engage in funds transfers with each other, the participating banks will sometimes be senders and sometimes receiving banks. With respect to payment orders other than Fedwires, the amounts of the various payment orders may be credited and debited to accounts of one bank with another or to a clearing house account of each bank and amounts owed and amounts due are netted. Settlement is made through a Federal Reserve Bank by charges to the Federal Reserve accounts of the net debtor banks and credits to the Federal Reserve accounts of the net creditor banks. In the case of Fedwires the sender's obligation is settled by a debit to the Federal Reserve account of the sender and a credit to the Federal Reserve account of the receiving bank at the time the receiving bank receives the payment order. Both of these cases are covered by subsection (a)(1) (A.C.A. § 4-4A-403(a)(1)). When the Federal Reserve settlement becomes final the obligation of the sender under Section 4A-402 (A.C.A. § 4-4A-402) is paid.

2. In some cases a bank does not settle an obligation owed to another bank through a Federal Reserve Bank. This is the case if one of the banks is a foreign

bank without access to the Federal Reserve payment system. In this kind of case, payment is usually made by credits or debits to accounts of the two banks with each other or to accounts of the two banks in a third bank. Suppose Bank B has an account in Bank A. Bank A advises Bank B that its account in Bank A has been credited \$1,000,000 and that the credit is immediately withdrawable. Bank A also instructs Bank B to pay \$1,000,000 to the account of Beneficiary in Bank B. This case is covered by subsection (a)(2) (A.C.A. § 4-4A-403(a)(2)). Bank B may want to immediately withdraw this credit. For example, it might do so by instructing Bank A to debit the account and pay some third party. Payment by Bank A to Bank B of Bank A's payment order occurs when the withdrawal is made. Suppose Bank B does not withdraw the credit. Since Bank B is the beneficiary's bank, one of the effects of receipt of payment by Bank B is that acceptance of Bank A's payment order automatically occurs at the time of payment. Section 4A-209(b)(2) (A.C.A. § 4-4A-209(b)(2)). Acceptance means that Bank B is obliged to pay \$1,000,000 to Beneficiary. Section 4A-404(a) (A.C.A. § 4-4A-404(a)). Subsection (a)(2) of Section 4A-403 (A.C.A. § 4-4A-403(a)(2)) states that payment does not occur until midnight if the credit is not withdrawn.



This allows Bank B an opportunity to reject the order if it does not have time to withdraw the credit to its account and it is not willing to incur the liability to Beneficiary before it has use of the funds represented by the credit.

3. Subsection (a)(3) (A.C.A. § 4-4A-403(a)(3)) applies to a case in which the sender (bank or nonbank) has a funded account in the receiving bank. If Sender has an account in Bank and issues a payment order to Bank, Bank can obtain payment from Sender by debiting the account of Sender, which pays its Section 4A-402 (A.C.A. § 4-4A-402) obligation to Bank when the debit is made.

4. Subsection (b) (A.C.A. § 4-4A-403(b)) deals with multilateral settlements made through a funds transfer system and is based on the CHIPS settlement system. In a funds transfer system such as CHIPS, which allows the various banks that transmit payment orders over the system to settle obligations at the end of each day, settlement is not based on individual payment orders. Each bank using the system engages in funds transfers with many other banks using the system. Settlement for any participant is based on the net credit or debit position of that participant with all other banks using the system. Subsection (b) (A.C.A. § 4-4A-403(b)) is designed to make clear that the obligations of any sender are paid when the net position of that sender is settled in accordance with the rules of the funds transfer system. This provision is intended to invalidate any argument, based

on common-law principles, that multilateral netting is not valid because mutuality of obligation is not present. Subsection (b) (A.C.A. § 4-4A-403(b)) dispenses with any mutuality of obligation requirements. Subsection (c) (A.C.A. § 4-4A-403(c)) applies to cases in which two banks send payment orders to each other during the day and settle with each other at the end of the day or at the end of some other period. It is similar to subsection (b) (A.C.A. § 4-4A-403(b)) in that it recognizes that a sender's obligation to pay a payment order is satisfied by a setoff. The obligations of each bank as sender to the other as receiving bank are obligations of the bank itself and not as representative of customers. These two sections (A.C.A. § 4-4A-403(b) and (c)) are important in the case of insolvency of a bank. They make clear that liability under Section 4A-402 (A.C.A. § 4-4A-402) is based on the net position of the insolvent bank after setoff.

5. Subsection (d) (A.C.A. § 4-4A-403(d)) relates to the uncommon case in which the sender doesn't have an account relationship with the receiving bank and doesn't settle through a Federal Reserve Bank. An example would be a customer that pays over the counter for a payment order that the customer issues to the receiving bank. Payment would normally be by cash, check or bank obligation. When payment occurs is determined by law outside Article 4A (A.C.A. § 4-4A-101 et seq.).

### Comment to § 4A-404 (A.C.A. § 4-4A-404)

1. The first sentence of subsection (a) (A.C.A. § 4-4A-404(a)) states the time when the obligation of the beneficiary's bank arises. The second and third sentences state when the beneficiary's bank must make funds available to the beneficiary. They also state the measure of damages for failure, after demand, to comply. Since the Expedited Funds Availability Act, 12 U.S.C. 4001 et seq., also governs funds availability in a funds transfer, the second and third sentences of subsection (a) (A.C.A. § 4-4A-404(a)) may be subject to preemption by that Act.

2. Subsection (a) (A.C.A. § 4-4A-404(a)) provides that the beneficiary of an accepted payment order may recover con-

sequential damages if the beneficiary's bank refuses to pay the order after demand by the beneficiary if the bank at that time had notice of the particular circumstances giving rise to the damages. Such damages are recoverable only to the extent the bank had "notice of the damages." The quoted phrase requires that the bank have notice of the general type or nature of the damages that will be suffered as a result of the refusal to pay and their general magnitude. There is no requirement that the bank have notice of the exact or even the approximate amount of the damages, but if the amount of damages is extraordinary the bank is entitled to notice of that fact. For example,

in *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951 (7th Cir. 1982), failure to complete a funds transfer of only \$27,000 required to retain rights to a very favorable ship charter resulted in a claim for more than \$2,000,000 of consequential damages. Since it is not reasonably foreseeable that a failure to make a relatively small payment will result in damages of this magnitude, notice is not sufficient if the beneficiary's bank has notice only that the \$27,000 is necessary to retain rights on a ship charter. The bank is entitled to notice that an exceptional amount of damages will result as well. For example, there would be adequate notice if the bank had been made aware that damages of \$1,000,000 or more might result.

3. Under the last clause of subsection (a) (A.C.A. § 4-4A-404(a)) the beneficiary's bank is not liable for damages if its refusal to pay was "because of a reasonable doubt concerning the right of the beneficiary to payment." Normally there will not be any question about the right of the beneficiary to receive payment. Normally, the bank should be able to determine whether it has accepted the payment order and, if it has been accepted, the first sentence of subsection (a) (A.C.A. § 4-4A-404(a)) states that the bank is obliged to pay. There may be uncommon cases, however, in which there is doubt whether acceptance occurred. For example, if acceptance is based on receipt of payment by the beneficiary's bank under Section 4A-403(a)(1) or (2) (A.C.A. § 4-4A-403(a)(1) or (2)), there may be cases in which the bank is not certain that payment has been received. There may also be cases in which there is doubt about whether the person demanding payment is the person identified in the payment order as beneficiary of the order.

The last clause of subsection (a) (A.C.A. § 4-4A-404(a)) does not apply to cases in which a funds transfer is being used to pay an obligation and a dispute arises between the originator and the beneficiary concerning whether the obligation is in fact owed. For example, the originator

may try to prevent payments to the beneficiary by the beneficiary's bank by alleging that the beneficiary is not entitled to payment because of fraud against the originator or a breach of contract relating to the obligation. The fraud or breach of contract claim of the originator may be grounds for recovery by the originator from the beneficiary after the beneficiary is paid, but it does not affect the obligation of the beneficiary's bank to pay the beneficiary. Unless the payment order has been canceled pursuant to Section 4A-211(c) (A.C.A. § 4-4A-211(c)), there is no excuse for refusing to pay the beneficiary and, in a proper case, the refusal may result in consequential damages. Except in the case of a book transfer, in which the beneficiary's bank is also the originator's bank, the originator of a funds transfer cannot cancel a payment order to the beneficiary's bank, with or without the consent of that bank, because the originator is not the sender of that order. Thus, the beneficiary's bank may safely ignore any instruction by the originator to withhold payment to the beneficiary.

4. Subsection (b) (A.C.A. § 4-4A-404(b)) states the duty of the beneficiary's bank to notify the beneficiary of receipt of the order. If acceptance occurs under Section 4A-209(b)(1) (A.C.A. § 4-4A-209(b)(1)) the beneficiary is normally notified. Thus, subsection (b) (A.C.A. § 4-4A-404(b)) applies primarily to cases in which acceptance occurs under Section 4A-209(b)(2) or (3) (A.C.A. § 4-4A-209(b)(2) or (3)). Notice under subsection (b) (A.C.A. § 4-4A-404(b)) is not required if the person entitled to the notice agrees or a funds transfer system rule provides that notice is not required and the beneficiary is given notice of the rule. In ACH transactions the normal practice is not to give notice to the beneficiary unless notice is requested by the beneficiary. This practice can be continued by adoption of a funds transfer system rule. Subsection (a) (A.C.A. § 4-4A-404(a)) is not subject to variation by agreement or by a funds transfer system rule.

### Comment to § 4A-405 (A.C.A. § 4-4A-405)

1. This section (A.C.A. § 4-4A-405) defines when the beneficiary's bank pays the beneficiary and when the obligation of the

beneficiary's bank under Section 4A-404 (A.C.A. § 4-4A-404) to pay the beneficiary is satisfied. In almost all cases the bank



will credit an account of the beneficiary when it receives a payment order. In the typical case the beneficiary is paid when the beneficiary is given notice of the right to withdraw the credit. Subsection (a)(i) (A.C.A. § 4-4A-405(a)(i)). In some cases payment might be made to the beneficiary not by releasing funds to the beneficiary, but by applying the credit to a debt of the beneficiary. Subsection (a)(ii) (A.C.A. § 4-4A-405(a)(ii)). In this case the beneficiary gets the benefit of the payment order because a debt of the beneficiary has been satisfied. The two principal cases in which payment will occur in this manner are setoff by the beneficiary's bank and payment of the proceeds of the payment order to a garnishing creditor of the beneficiary. These cases are discussed in Comment 2 to Section 4A-502 (A.C.A. § 4-4A-502).

2. If a beneficiary's bank releases funds to the beneficiary before it receives payment from the sender of the payment order, it assumes the risk that the sender may not pay the sender's order because of suspension of payments or other reason. Subsection (c) (A.C.A. § 4-4A-405(c)). As stated in Comment 5 to Section 4A-209 (A.C.A. § 4-4A-209), the beneficiary's bank can protect itself against this risk by delaying acceptance. But if the bank accepts the order it is obliged to pay the beneficiary. If the beneficiary's bank has given the beneficiary notice of the right to withdraw a credit made to the beneficiary's account, the beneficiary has received payment from the bank. Once payment has been made to the beneficiary with respect to an obligation incurred by the bank under Section 4A-404(a) (A.C.A. § 4-4A-404(a)), the payment cannot be recovered by the beneficiary's bank unless subsection (d) or (e) (A.C.A. § 4-4A-405(d) or (e)) applies. Thus, a right to withdraw a credit cannot be revoked if the right to withdraw constituted payment of the bank's obligation. This principle applies even if funds were released as a "loan" (see Comment 5 to Section 4A-209 (A.C.A. § 4-4A-209)), or were released subject to a condition that they would be repaid in the event the bank does not receive payment from the sender of the payment order, or the beneficiary agreed to return the payment if the bank did not receive payment from the sender.

3. Subsection (c) (A.C.A. § 4-4A-405(c)) is subject to an exception stated in subsection

(d) (A.C.A. § 4-4A-405(d)) which is intended to apply to automated clearing house transfers. ACH transfers are made in batches. A beneficiary's bank will normally accept, at the same time and as part of a single batch, payment orders with respect to many different originator's banks. Comment 2 to Section 4A-206 (A.C.A. § 4-4A-206). The custom in ACH transactions is to release funds to the beneficiary early on the payment date even though settlement to the beneficiary's bank does not occur until later in the day. The understanding is that payments to beneficiaries are provisional until the beneficiary's bank receives settlement. This practice is similar to what happens when a depository bank releases funds with respect to a check forwarded for collection. If the check is dishonored the bank is entitled to recover the funds from the customer. ACH transfers are widely perceived as check substitutes. Section 4A-405(d) (A.C.A. § 4-4A-405(d)) allows the funds transfer system to adopt a rule making payments to beneficiaries provisional. If such a rule is adopted, a beneficiary's bank that releases funds to the beneficiary will be able to recover the payment if it doesn't receive payment of the payment order that it accepted. There are two requirements with respect to the funds transfer system rule. The beneficiary, the beneficiary's bank and the originator's bank must all agree to be bound by the rule and the rule must require that both the beneficiary and the originator be given notice of the provisional nature of the payment before the funds transfer is initiated. There is no requirement that the notice be given with respect to a particular funds transfer. Once notice of the provisional nature of the payment has been given, the notice is effective for all subsequent payments to or from the person to whom the notice was given. Subsection (d) (A.C.A. § 4-4A-405(d)) provides only that the funds transfer system rule must require notice to the beneficiary and the originator. The beneficiary's bank will know what the rule requires, but it has no way of knowing whether the originator's bank complied with the rule. Subsection (d) (A.C.A. § 4-4A-405(d)) does not require proof that the originator received notice. If the originator's bank failed to give the required notice and the originator suffered as a result, the appropriate rem-

edy is an action by the originator against the originator's bank based on that failure. But the beneficiary's bank will not be able to get the benefit of subsection (d) (A.C.A. § 4-4A-405(d)) unless the beneficiary had notice of the provisional nature of the payment because subsection (d) (A.C.A. § 4-4A-405(d)) requires an agreement by the beneficiary to be bound by the rule. Implicit in an agreement to be bound by a rule that makes a payment provisional is a requirement that notice be given of what the rule provides. The notice can be part of the agreement or separately given. For example, notice can be given by providing a copy of the system's operating rules.

With respect to ACH transfers made through a Federal Reserve Bank acting as an intermediary bank, the Federal Reserve Bank is obliged under Section 4A-402(b) (A.C.A. § 4-4A-402(b)) to pay a beneficiary's bank that accepts the payment order. Unlike Fedwire transfers, under current ACH practice a Federal Reserve Bank that processes a payment order does not obligate itself to pay if the originator's bank fails to pay the Federal Reserve Bank. It is assumed that the Federal Reserve will use its right of preemption, which is recognized in Section 4A-107 (A.C.A. § 4-4A-107) to disclaim the Section 4A-402(b) (A.C.A. § 4-4A-402(b)) obligation in ACH transactions if it decides to retain the provisional payment rule.

4. Subsection (e) (A.C.A. § 4-4A-405(e)) is another exception to subsection (c) (A.C.A. § 4-4A-405(c)). It refers to funds transfer systems having loss-sharing rules described in the subsection. CHIPS

has proposed a rule that fits the description. Under the CHIPS loss-sharing rule the CHIPS banks will have agreed to contribute funds to allow the system to settle for payment orders sent over the system during the day in the event that one or more banks are unable to meet their settlement obligations. Subsection (e) (A.C.A. § 4-4A-405(e)) applies only if CHIPS fails to settle despite the loss-sharing rule. Since funds under the loss-sharing rule will be instantly available to CHIPS and will be in an amount sufficient to cover any failure that can be reasonably anticipated, it is extremely unlikely that CHIPS would ever fail to settle. Thus, subsection (e) (A.C.A. § 4-4A-405(e)) addresses an event that should never occur. If that event were to occur, all payment orders made over the system would be canceled under the CHIPS rule. Thus, no bank would receive settlement, whether or not a failed bank was involved in a particular funds transfer. Subsection (e) (A.C.A. § 4-4A-405(e)) provides that each funds transfer in which there is a payment order with respect to which there is a settlement failure is unwound. Acceptance by the beneficiary's bank in each funds transfer is nullified. The consequences of nullification are that the beneficiary has no right to receive or retain payment by the beneficiary's bank, no payment is made by the originator to the beneficiary and each sender in the funds transfer is, subject to Section 4A-402(e) (A.C.A. § 4-4A-402(e)), not obliged to pay its payment order and is entitled to refund under Section 4A-402(d) (A.C.A. § 4-4A-402(d)) if it has already paid.

#### Comment to § 4A-406 (A.C.A. § 4-4A-406)

1. Subsection (a) (A.C.A. § 4-4A-406(a)) states the fundamental rule of Article 4A (A.C.A. § 4-4A-101 et seq.) that payment by the originator to the beneficiary is accomplished by providing to the beneficiary the obligation of the beneficiary's bank to pay. Since this obligation arises when the beneficiary's bank accepts a payment order, the originator pays the beneficiary at the time of acceptance and in the amount of the payment order accepted.

2. In a large percentage of funds transfers, the transfer is made to pay an obli-

gation of the originator. Subsection (a) (A.C.A. § 4-4A-406(a)) states that the beneficiary is paid by the originator when the beneficiary's bank accepts a payment order for the benefit of the beneficiary. When that happens the effect under subsection (b) (A.C.A. § 4-4A-406(b)) is to substitute the obligation of the beneficiary's bank for the obligation of the originator. The effect is similar to that under Article 3 (A.C.A. § 4-3-101 et seq.) if a cashier's check payable to the beneficiary had been taken by the beneficiary. Normally, payment by funds transfer is



sought by the beneficiary because it puts money into the hands of the beneficiary more quickly. As a practical matter the beneficiary and the originator will nearly always agree to the funds transfer in advance. Under subsection (b) (A.C.A. § 4-4A-406(b)) acceptance by the beneficiary's bank will result in discharge of the obligation for which payment was made unless the beneficiary had made a contract with respect to the obligation which did not permit payment by the means used. Thus, if there is no contract of the beneficiary with respect to the means of payment of the obligation, acceptance by the beneficiary's bank of a payment order to the account of the beneficiary can result in discharge.

3. Suppose Beneficiary's contract stated that payment of an obligation owed by Originator was to be made by a cashier's check of Bank A. Instead, Originator paid by a funds transfer to Beneficiary's account in Bank B. Bank B accepted a payment order for the benefit of Beneficiary by immediately notifying Beneficiary that the funds were available for withdrawal. Before Beneficiary had a reasonable opportunity to withdraw the funds Bank B suspended payments. Under the unless clause of subsection (b) (A.C.A. § 4-4A-406(b)) Beneficiary is not required to accept the payment as discharging the obligation owed by Originator to Beneficiary if Beneficiary's contract means that Beneficiary was not required to accept payment by wire transfer. Beneficiary could refuse the funds transfer as payment of the obligation and could resort to rights under the underlying contract to enforce the obligation. The rationale is that Originator cannot impose the risk of Bank B's insolvency on Beneficiary if Beneficiary had specified another means of payment that did not entail that risk. If Beneficiary is required to accept Originator's payment, Beneficiary would suffer a loss that would not have occurred if payment had been made by a cashier's check on Bank A, and Bank A has not suspended payments. In this case Originator will have to pay twice. It is obliged to pay the amount of its payment order to the bank that accepted it and has to pay the obligation it owes to Beneficiary which has not been discharged. Under the last sentence of subsection (b) (A.C.A. § 4-4A-406(b)) Originator is subrogated to Beneficiary's

right to receive payment from Bank B under Section 4A-404(a) (A.C.A. § 4-4A-404(a)).

4. Suppose Beneficiary's contract called for payment by a Fedwire transfer to Bank B, but the payment order accepted by Bank B was not a Fedwire transfer. Before the funds were withdrawn by Beneficiary, Bank B suspended payments. The sender of the payment order to Bank B paid the amount of the order to Bank B. In this case the payment by Originator did not comply with Beneficiary's contract, but the noncompliance did not result in a loss to Beneficiary as required by subsection (b)(iv) (A.C.A. § 4-4A-406(b)(iv)). A Fedwire transfer avoids the risk of insolvency of the sender of the payment order to Bank B, but it does not affect the risk that Bank B will suspend payments before withdrawal of the funds by Beneficiary. Thus, the unless clause of subsection (b) (A.C.A. § 4-4A-406(b)) is not applicable and the obligation owed to Beneficiary is discharged.

5. Charges of receiving banks in a funds transfer normally are nominal in relationship to the amount being paid by the originator to the beneficiary. Wire transfers are normally agreed to in advance and the parties may agree concerning how these charges are to be divided between the parties. Subsection (c) (A.C.A. § 4-4A-406(c)) states a rule that applies in the absence of agreement. In some funds transfers charges of banks that execute payment orders are collected by deducting the charges from the amount of the payment order issued by the bank, i.e. the bank issues a payment order that is slightly less than the amount of the payment order that is being executed. The process is described in Comment 3 to Section 4A-302 (A.C.A. § 4-4A-302). The result in such a case is that the payment order accepted by the beneficiary's bank will be slightly less than the amount of the originator's order. Subsection (c) (A.C.A. § 4-4A-406(c)) recognizes the principle that a beneficiary is entitled to full payment of a debt paid by wire transfer as a condition to discharge. On the other hand, subsection (c) (A.C.A. § 4-4A-406(c)) prevents a beneficiary from denying the originator the benefit of the payment by asserting that discharge did not occur because deduction of bank charges resulted in less than full payment. The

typical case is one in which the payment is made to exercise a valuable right such as an option which is unfavorable to the beneficiary. Subsection (c) (A.C.A. § 4-4A-

406(c)) allows discharge notwithstanding the deduction unless the originator fails to reimburse the beneficiary for the deducted charges after demand by the beneficiary.

### Comment to § 4A-501 (A.C.A. § 4-4A-501)

1. This section (A.C.A. § 4-4A-501) is designed to give some flexibility to Article 4A (A.C.A. § 4-4A-101 et seq.). Funds transfer system rules govern rights and obligations between banks that use the system. They may cover a wide variety of matters such as form and content of payment orders, security procedures, cancellation rights and procedures, indemnity rights, compensation rules for delays in completion of a funds transfer, time and method of settlement, credit restrictions with respect to senders of payment orders and risk allocation with respect to suspension of payments by a participating bank. Funds transfer system rules can be very effective in supplementing the provisions of Article 4A (A.C.A. § 4-4A-101 et seq.) and in filling gaps that may be present in Article 4A (A.C.A. § 4-4A-101 et seq.). To the extent they do not conflict with Article 4A (A.C.A. § 4-4A-101 et seq.) there is no problem with respect to their effectiveness. In that case they merely supplement Article 4A (A.C.A. § 4-4A-101 et seq.). Section 4A-501 (A.C.A. § 4-4A-501) goes further. It states that unless the contrary is stated, funds transfer system rules can override provisions of Article 4A (A.C.A. § 4-4A-101 et seq.). Thus, rights and obligations of a sender bank and a receiving bank with respect to each other can be different from that stated in Article 4A (A.C.A. § 4-4A-101 et seq.) to the extent a funds transfer system rule applies. Since funds transfer system rules are defined as those governing the relationship between participating banks, a rule can have a direct effect only on participating banks. But a rule that affects the conduct of a participating bank may indirectly affect the rights of nonparticipants such as the originator or beneficiary of a funds transfer, and such a rule can be effective even though it may affect nonparticipants without their consent. For example, a rule

might prevent execution of a payment order or might allow cancellation of a payment order with the result that a funds transfer is not completed or is delayed. But a rule purporting to define rights and obligations of nonparticipants in the system would not be effective to alter Article 4A (A.C.A. § 4-4A-101 et seq.) rights because the rule is not within the definition of funds transfer system rule. Rights and obligations arising under Article 4A (A.C.A. § 4-4A-101 et seq.) may also be varied by agreement of the affected parties, except to the extent Article 4A (A.C.A. § 4-4A-101 et seq.) otherwise provides. Rights and obligations arising under Article 4A (A.C.A. § 4-4A-101 et seq.) can also be changed by Federal Reserve regulations and operating circulars of Federal Reserve Banks. Section 4A-107 (A.C.A. § 4-4A-107).

2. Subsection (b)(ii) (A.C.A. § 4-4A-501(b)(ii)) refers to ACH transfers. Whether an ACH transfer is made through an automated clearing house of a Federal Reserve Bank or through an automated clearing house of another association or bank, the rights and obligations of the originator's bank and the beneficiary's bank are governed by uniform rules adopted by various associations of banks in various parts of the nation. With respect to transfers in which a Federal Reserve Bank acts as intermediary bank these rules may be incorporated, in whole or in part, in operating circulars of the Federal Reserve Bank. Even if not so incorporated these rules can still be binding on the association banks. If a transfer is made through a Federal Reserve Bank, the rules are effective under subsection (b)(ii) (A.C.A. § 4-4A-501(b)(ii)). If the transfer is not made through a Federal Reserve Bank, the association rules are effective under subsection (b)(i) (A.C.A. § 4-4A-501(b)(i)).



**Comment to § 4A-502 (A.C.A. § 4-4A-502)**

1. When a receiving bank accepts a payment order, the bank normally receives payment from the sender by debiting an authorized account of the sender. In accepting the sender's order the bank may be relying on a credit balance in the account. If creditor process is served on the bank with respect to the account before the bank accepts the order but the bank employee responsible for the acceptance was not aware of the creditor process at the time the acceptance occurred, it is unjust to the bank to allow the creditor process to take the credit balance on which the bank may have relied. Subsection (b) (A.C.A. § 4-4A-502(b)) allows the bank to obtain payment from the sender's account in this case. Under that provision, the balance in the sender's account to which the creditor process applies is deemed to be reduced by the amount of the payment order unless there was sufficient time for notice of the service of creditor process to be received by personnel of the bank responsible for the acceptance.

2. Subsection (c) (A.C.A. § 4-4A-502(c)) deals with payment orders issued to the beneficiary's bank. The bank may credit the beneficiary's account when the order is received, but under Section 4A-404(a) (A.C.A. § 4-4A-404(a)) the bank incurs no obligation to pay the beneficiary until the order is accepted pursuant to Section 4A-209(b) (A.C.A. § 4-4A-209(b)). Thus, before acceptance, the credit to the beneficiary's account is provisional. But under Section 4A-209(b) (A.C.A. § 4-4A-209(b)) acceptance occurs if the beneficiary's bank pays the beneficiary pursuant to Section 4A-405(a) (A.C.A. § 4-4A-405(a)). Under that provision, payment occurs if the credit to the beneficiary's account is applied to a debt of the beneficiary. Subsection (c)(1) (A.C.A. § 4-4A-502(c)(1)) allows the bank to credit the beneficiary's account with respect to a payment order and to accept the order by setting off the credit against an obligation owed to the bank or applying the credit to creditor process with respect to the account.

Suppose a beneficiary's bank receives a payment order for the benefit of a customer. Before the bank accepts the order, the bank learns that creditor process has

been served on the bank with respect to the customer's account. Normally there is no reason for a beneficiary's bank to reject a payment order, but if the beneficiary's account is garnished, the bank may be faced with a difficult choice. If it rejects the order, the garnishing creditor's potential recovery of funds of the beneficiary is frustrated. It may be faced with a claim by the creditor that the rejection was a wrong to the creditor. If the bank accepts the order, the effect is to allow the creditor to seize funds of its customer, the beneficiary. Subsection (c)(3) (A.C.A. § 4-4A-502(c)(3)) gives the bank no choice in this case. It provides that it may not favor its customer over the creditor by rejecting the order. The beneficiary's bank may rightfully reject only if there is an independent basis for rejection.

3. Subsection (c)(2) (A.C.A. § 4-4A-502(c)(2)) is similar to subsection (b) (A.C.A. § 4-4A-502(b)). Normally the beneficiary's bank will release funds to the beneficiary shortly after acceptance or it will accept by releasing funds. Since the bank is bound by a garnishment order served before funds are released to the beneficiary, the bank might suffer a loss if funds were released without knowledge that a garnishment order had been served. Subsection (c)(2) (A.C.A. § 4-4A-502(c)(2)) protects the bank if it did not have adequate notice of the garnishment when the funds were released.

4. A creditor may want to reach funds involved in a funds transfer. The creditor may try to do so by serving process on the originator's bank, an intermediary bank or the beneficiary's bank. The purpose of subsection (d) (A.C.A. § 4-4A-502(d)) is to guide the creditor and the court as to the proper method of reaching the funds involved in a funds transfer. A creditor of the originator can levy on the account of the originator in the originator's bank before the funds transfer is initiated, but that levy is subject to the limitations stated in subsection (b) (A.C.A. § 4-4A-502(b)). The creditor of the originator cannot reach any other funds because no property of the originator is being transferred. A creditor of the beneficiary cannot levy on property of the originator and until the funds transfer is completed by acceptance by the

beneficiary's bank of a payment order for the benefit of the beneficiary, the beneficiary has no property interest in the funds transfer which the beneficiary's creditor can reach. A creditor of the beneficiary that wants to reach the funds to be received by the beneficiary must serve creditor process on the beneficiary's bank to reach the obligation of the beneficiary's bank to pay the beneficiary which arises upon acceptance by the beneficiary's bank

under Section 4A-404(a) (A.C.A. § 4-4A-404(a)).

5. "Creditor process" is defined in subsection (a) (A.C.A. § 4-4A-502(a)) to cover a variety of devices by which a creditor of the holder of a bank account or a claimant to a bank account can seize the account. Procedure and nomenclature varies widely from state to state. The term used in Section 4A-502 (A.C.A. § 4-4A-502) is a generic term.

#### **Comment to § 4A-503 (A.C.A. § 4-4A-503)**

This section (A.C.A. § 4-4A-503) is related to Section 4A-502(d) (A.C.A. § 4-4A-502(d)) and to Comment 4 to Section 4A-502 (A.C.A. § 4-4A-502). It is designed to prevent interruption of a funds transfer after it has been set in motion. The initiation of a funds transfer can be prevented by enjoining the originator or the originator's bank from issuing a payment order. After the funds transfer is completed by acceptance of a payment order by the beneficiary's bank, that bank can be enjoined from releasing funds to the benefi-

ciary or the beneficiary can be enjoined from withdrawing the funds. No other injunction is permitted. In particular, intermediary banks are protected, and injunctions against the originator and the originator's bank are limited to issuance of a payment order. Except for the beneficiary's bank, nobody can be enjoined from paying a payment order, and no receiving bank can be enjoined from receiving payment from the sender of the order that it accepted.

#### **Comment to § 4A-504 (A.C.A. § 4-4A-504)**

1. Subsection (a) (A.C.A. § 4-4A-504(a)) concerns priority among various obligations that are to be paid from the same account. A customer may have written checks on its account with the receiving bank and may have issued one or more payment orders payable from the same account. If the account balance is not sufficient to cover all of the checks and payment orders, some checks may be dishonored and some payment orders may not be accepted. Although there is no concept of wrongful dishonor of a payment order in Article 4A (A.C.A. § 4-4A-101 et seq.) in the absence of an agreement to honor by the receiving bank, some rights and obligations may depend on the amount in the customer's account. Section 4A-209(b)(3) and Section 4A-210(b) (A.C.A. §§ 4-4A-209(b)(3) and 4-4A-210(b)). Whether dishonor of a check is wrongful also may depend upon the balance in the customer's account. Under subsection (a) (A.C.A. § 4-4A-504(a)), the

bank is not required to consider the competing items and payment orders in any particular order. Rather it may charge the customer's account for the various items and orders in any order. Suppose there is \$12,000 in the customer's account. If a check for \$5,000 is presented for payment and the bank receives a \$10,000 payment order from the customer, the bank could dishonor the check and accept the payment order. Dishonor of the check is not wrongful because the account balance was less than the amount of the check after the bank charged the account \$10,000 on account of the payment order. Or, the bank could pay the check and not execute the payment order because the amount of the order is not covered by the balance in the account.

2. Subsection (b) (A.C.A. § 4-4A-504(b)) follows Section 4-208(b) (A.C.A. § 4-208(b)) in using the first-in-first-out rule for determining the order in which credits to an account are withdrawn.



**Comment to § 4A-505 (A.C.A. § 4-4A-505)**

This section (A.C.A. § 4-4A-505) is in the nature of a statute of repose for objecting to debits made to the customer's account. A receiving bank that executes payment orders of a customer may have received payment from the customer by debiting the customer's account with respect to a payment order that the customer was not required to pay. For example, the payment order may not have been authorized or verified pursuant to Section 4A-202 (A.C.A. § 4-4A-202) or the funds transfer may not have been completed. In either case the receiving bank is obliged to refund the payment to the customer and this obligation to refund payment cannot be varied by agreement. Section 4A-204

and Section 4A-402 (A.C.A. §§ 4-4A-204 and 4-4A-402). Refund may also be required if the receiving bank is not entitled to payment from the customer because the bank erroneously executed a payment order. Section 4A-303 (A.C.A. § 4-4A-303). A similar analysis applies to that case. Section 4A-402(d) and (f) (A.C.A. § 4-4A-402(d) and (f)) require refund and the obligation to refund may not be varied by agreement. Under 4A-505 (A.C.A. § 4-4A-505), however, the obligation to refund may not be asserted by the customer if the customer has not objected to the debiting of the account within one year after the customer received notification of the debit.

**Comment to § 4A-506 (A.C.A. § 4-4A-506)**

1. A receiving bank is required to pay interest on the amount of a payment order received by the bank in a number of situations. Sometimes the interest is payable to the sender and in other cases it is payable to either the originator or the beneficiary of the funds transfer. The relevant provisions are Sections 4A-204(a), Section 4A-209(b)(3), Section 4A-210(b), Section 4A-305(a), Section 4A-402(d) and Section 4A-404(b) (A.C.A. §§ 4-4A-204(a), 4-4A-209(b)(3), 4-4A-210(b), 4-4A-305(a), 4-4A-402(d), and 4-4A-404(b)). The rate of interest may be governed by a funds transfer system rule or by agreement as stated in subsection (a) (A.C.A. § 4-4A-506(a)). If subsection (a) (A.C.A. § 4-4A-506(a)) doesn't apply, the rate is determined under subsection (b) (A.C.A. § 4-4A-506(b)). Subsection (b) (A.C.A. § 4-4A-506(b)) is illustrated by the following example. A bank is obliged to pay interest on \$1,000,000 for three days, July 3, July 4, and July 5. The published Fed Funds rate is .082 for July 3 and .081 for July 5. There is no published rate for July 4 because that day is not a banking day. The rate for July 3 applies to July 4. The applicable Fed Funds rate is .08167 (the average of .082, .082, and .081) divided by 360 which equals .0002268. The amount of interest payable is  $\$1,000,000 \times .0002268 \times 3 = \$680.40$ .

2. In some cases, interest is payable in

spite of the fact that there is no fault by the receiving bank. The last sentence of subsection (b) (A.C.A. § 4-4A-506(b)) applies to those cases. For example, a funds transfer might not be completed because the beneficiary's bank rejected the payment order issued to it by the originator's bank or an intermediary bank. Section 4A-402(c) (A.C.A. § 4-4A-402(c)) provides that the originator is not obliged to pay its payment order and Section 4A-402(d) (A.C.A. § 4-4A-402(d)) provides that the originator's bank must refund any payment received plus interest. The requirement to pay interest in this case is not based on fault by the originator's bank. Rather, it is based on restitution. Since the originator's bank had the use of the originator's money, it is required to pay the originator for the value of that use. The value of that use is not determined by multiplying the interest rate by the refundable amount because the originator's bank is required to deposit with the Federal Reserve a percentage of the bank's deposits as a reserve requirement. Since that deposit does not bear interest, the bank had use of the refundable amount reduced by a percentage equal to the reserve requirement. If the reserve requirement is 12 %, the amount of interest payable by the bank under the formula stated in subsection (b) (A.C.A. § 4-4A-506(b)) is reduced by 12 %.

**Comment to § 4A-507 (A.C.A. § 4-4A-507)**

1. Funds transfers are typically interstate or international in character. If part of a funds transfer is governed by Article 4A (A.C.A. § 4-4A-101 et seq.) and another part is governed by other law, the rights and obligations of parties to the funds transfer may be unclear because there is no clear consensus in various jurisdictions concerning the juridical nature of the transaction. Unless all of a funds transfer is governed by a single law it may be very difficult to predict the result if something goes wrong in the transfer. Section 4A-507 (A.C.A. § 4-4A-507) deals with this problem. Subsection (b) (A.C.A. § 4-4A-507(b)) allows parties to a funds transfer to make a choice-of-law agreement. Subsection (c) (A.C.A. § 4-4A-507(c)) allows a funds transfer system to select the law of a particular jurisdiction to govern funds transfers carried out by means of the system. Subsection (a) (A.C.A. § 4-4A-507(a)) states residual rules if no choice of law has occurred under subsection (b) or subsection (c) (A.C.A. § 4-4A-507(b) or (c)).

2. Subsection (a) (A.C.A. § 4-4A-507(a)) deals with three sets of relationships. Rights and obligations between the sender of a payment order and the receiving bank are governed by the law of the jurisdiction in which the receiving bank is located. If the receiving bank is the beneficiary's bank the rights and obligations of the beneficiary are also governed by the law of the jurisdiction in which the receiving bank is located. Suppose Originator, located in Canada, sends a payment order to Originator's Bank located in a state in which Article 4A (A.C.A. § 4-4A-101 et seq.) has been enacted. The order is for payment to an account of Beneficiary in a bank in England. Under subsection (a)(1) (A.C.A. § 4-4A-507(a)(1)), the rights and obligations of Originator and Originator's Bank toward each other are governed by Article 4A (A.C.A. § 4-4A-101 et seq.) if an action is brought in a court in the Article 4A (A.C.A. § 4-4A-101 et seq.) state. If an action is brought in a Canadian court, the conflict of laws issue will be determined by Canadian law which might or might not apply the law of the state in which Originator's Bank is located. If that law is applied, the execution of Originator's or-

der will be governed by Article 4A (A.C.A. § 4-4A-101 et seq.), but with respect to the payment order of Originator's Bank to the English bank, Article 4A (A.C.A. § 4-4A-101 et seq.) may or may not be applied with respect to the rights and obligations between the two banks. The result may depend upon whether action is brought in a court in the state in which Originator's Bank is located or in an English court. Article 4A (A.C.A. § 4-4A-101 et seq.) is binding only on a court in a state that enacts it. It can have extraterritorial effect only to the extent courts of another jurisdiction are willing to apply it. Subsection (c) (A.C.A. § 4-4A-507(c)) also bears on the issues discussed in this Comment.

Under Section 4A-406 (A.C.A. § 4-4A-406) payment by the originator to the beneficiary of the funds transfer occurs when the beneficiary's bank accepts a payment order for the benefit of the beneficiary. A jurisdiction in which Article 4A (A.C.A. § 4-4A-101 et seq.) is not in effect may follow a different rule or it may not have a clear rule. Under Section 4A-507(a)(3) (A.C.A. § 4-4A-507(a)(3)) the issue is governed by the law of the jurisdiction in which the beneficiary's bank is located. Since the payment to the beneficiary is made through the beneficiary's bank it is reasonable that the issue of when payment occurs be governed by the law of the jurisdiction in which the bank is located. Since it is difficult in many cases to determine where a beneficiary is located, the location of the beneficiary's bank provides a more certain rule.

3. Subsection (b) (A.C.A. § 4-4A-507(b)) deals with choice-of-law agreements and it gives maximum freedom of choice. Since the law of funds transfers is not highly developed in the case law there may be a strong incentive to choose the law of a jurisdiction in which Article 4A (A.C.A. § 4-4A-101 et seq.) is in effect because it provides a greater degree of certainty with respect to the rights of various parties. With respect to commercial transactions, it is often said that "[u]niformity and predictability based upon commercial convenience are the prime considerations in making the choice of governing law..." R. Leflar, *American Conflicts Law*, § 185 (1977). Subsection



(b) (A.C.A. § 4-4A-507(b)) is derived in part from recently enacted choice-of-law rules in the States of New York and California. N.Y. Gen. Obligations Law 5-1401 (McKinney's 1989 Supp.) and California Civil Code § 1646.5. This broad endorsement of freedom of contract is an enhancement of the approach taken by Restatement (Second) of Conflict of Laws § 187(b) (1971). The Restatement recognizes the basic right of freedom of contract, but the freedom granted the parties may be more limited than the freedom granted here. Under the formulation of the Restatement, if there is no substantial relationship to the jurisdiction whose law is selected and there is no "other" reasonable basis for the parties' choice, then the selection of the parties need not be honored by a court. Further, if the choice is violative of a fundamental policy of a state which has a materially greater interest than the chosen state, the selection could be disregarded by a court. Those limitations are not found in subsection (b) (A.C.A. § 4-4A-507(b)).

4. Subsection (c) (A.C.A. § 4-4A-507(c)) may be the most important provision in regard to creating uniformity of law in funds transfers. Most rights stated in Article 4A (A.C.A. § 4-4A-101 et seq.) regard parties who are in privity of contract such as originator and beneficiary, sender and receiving bank, and beneficiary's bank and beneficiary. Since they are in privity they can make a choice of law by agreement. But that is not always the case. For example, an intermediary bank that improperly executes a payment order is not in privity with either the originator or the beneficiary. The ability of a funds transfer system to make a choice of law by rule is a convenient way of dispensing with individual agreements and to cover cases in which agreements are not feasible. It is probable that funds transfer systems will adopt a governing law to increase the

certainty of commercial transactions that are effected over such systems. A system rule might adopt the law of an Article 4A (A.C.A. § 4-4A-101 et seq.) state to govern transfers on the system in order to provide a consistent, unitary, law governing all transfers made on the system. To the extent such system rules develop, individual choice-of-law agreements become unnecessary.

Subsection (c) (A.C.A. § 4-4A-507(c)) has broad application. A system choice of law applies not only to rights and obligations between banks that use the system, but may also apply to other parties to the funds transfer so long as some part of the transfer was carried out over the system. The originator and any other sender or receiving bank in the funds transfer is bound if at the time it issues or accepts a payment order it had notice that the funds transfer involved use of the system and that the system chose the law of a particular jurisdiction. Under Section 4A-107 (A.C.A. § 4-4A-107), the Federal Reserve by regulation could make a similar choice of law to govern funds transfers carried out by use of Federal Reserve Banks. Subsection (d) (A.C.A. § 4-4A-507(d)) is a limitation on subsection (c) (A.C.A. § 4-4A-507(c)). If parties have made a choice-of-law agreement that conflicts with a choice of law made under subsection (c) (A.C.A. § 4-4A-507(c)), the agreement prevails.

5. Subsection (e) (A.C.A. § 4-4A-507(e)) addresses the case in which a funds transfer involves more than one funds transfer system and the systems adopt conflicting choice-of-law rules. The rule that has the most significant relationship to the matter at issue prevails. For example, each system should be able to make a choice of law governing payment orders transmitted over that system with regard to a choice of law made by another system.

**ARTICLE 5**  
**(A.C.A. § 4-5-101 ET SEQ.)**

**Comment to § 5-101 (A.C.A. § 4-5-101)**

Letters of credit have been known and used for many years, in both international and domestic transactions, and in many forms; but except for a few provisions, like Section 135 of the Negotiable Instruments Law, they have not been the subject of statutory enactment, and the law concerning them has been developed in the cases.

This provision of the Negotiable Instruments Law is no longer in the Code. See the contrary rule in Section 3-410 (A.C.A. § 4-3-410) on the definition of acceptance. The other source of law respecting letters

of credit is the law of contracts with the occasional unfortunate excursions into the law of guaranty. This Article (Chapter) is intended within its limited scope (see Comment to Section 5-102 (A.C.A. § 4-5-102)) to set an independent theoretical frame for the further development of letters of credit.

*Cross References:*

Sections 5-102 (A.C.A. § 4-5-102), 5-103 (A.C.A. § 4-5-103) and 3-410 (A.C.A. § 4-3-410).

**Comment to § 5-102 (A.C.A. § 4-5-102)**

*Prior Uniform Statutory Provisions:*

None.

*Purposes:*

To define the transactions to which this Article (Chapter) applies and to indicate that the rules stated are not intended to be exhaustive of the law applicable to letters of credit.

1. Although letters of credit are commonly thought of as being issued by banks and private bankers, other financing institutions can and do enter into transactions which fit the traditional concept of letters of credit. This is particularly true when the financing institution at the request of a buyer of goods promises the seller of goods that it will pay or accept drafts of demands for payment on either the buyer or itself if the drafts are accompanied by documents of title covering the goods involved in the sales contract. Banks and private bankers also issue money credits which do not require documents of title to be presented as one of the conditions of honor. So far as these institutions are concerned the accompanying papers can range from a certification that certain building contracts have been performed in whole or in part or a notice that goods have been sent or a notice of default of some kind into the more traditional document of title. Subsection (1) (A.C.A. § 4-5-102(1)) attempts to make clear that automatic application of this Article (Chapter) to the transaction in question

depends upon the nature of the issuer. Paragraph (1)(a) (A.C.A. § 4-5-102(1)(a)) is applicable to banks and states that whenever the promise to honor is conditioned on presentation of any piece of paper, the transaction is within this Article (Chapter) whereas paragraph (1)(b) (A.C.A. § 4-5-102(1)(b)) makes automatic application of the Article (Chapter) to transactions involving issuers other than banks dependent upon the requirement of a document of title.

Since banks issue "clean" as well as "documentary" credits and since other persons may desire to bring transactions involving papers other than documents of title within the coverage of this Article (Chapter), paragraph (1)(c) (A.C.A. § 4-5-102(1)(c)) permits the issuer to do so by conspicuous notation that the paper is a letter of credit. Whether a transaction falls within the mandatory or the permissive paragraphs of subsection (1) (A.C.A. § 4-5-102(1)) is also of importance on the question of payment of funds held by an issuer at the time of its insolvency. (See 5-117 (A.C.A. § 4-5-117).)

Subsection (2) (A.C.A. § 4-5-102(2)) states the negative of the rules of applicability of subsection (1) (A.C.A. § 4-5-102(1)) for greater clarity but is not intended to either enlarge or limit the tests of applicability there laid down.

2. Subsection (3) (A.C.A. § 4-5-102(3)) recognizes that in the present state of the law and variety of practices as to letters of



credit, no statute can effectively or wisely codify all the possible law of letters of credit, no statute can effectively or wisely codify all the possible law of letters of credit without stultifying further development of this useful financing device. The more important areas not covered by this Article (Chapter) revolve around the question of when documents in fact and in law do or do not comply with the terms of the credit. In addition such minor matters as the absence of expiration dates and the effect of extending shipment but not expiration dates are also left untouched for future adjudication. The rules embodied in the Article (Chapter) can be viewed as those expressing the fundamental theories underlying letters of credit. For this reason the second sentence of subsection (3) (A.C.A. § 4-5-102(3)) makes explicit the court's power to apply a particular rule by analogy to cases not within its terms, or to refrain from doing so. Under Section 1-102(1) (A.C.A. § 4-1-102(1)) such application is to follow the canon of liberal interpretation to promote underlying purposes and policies. Since the law of

letters of credit is still developing, conscious use of that canon and attention to fundamental theory by the court are peculiarly appropriate.

*Cross Reference:*

Section 1-102 (A.C.A. § 4-1-102).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Conspicuous". Section 1-201 (A.C.A. § 4-1-201).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Documentary draft". Section 5-103 (A.C.A. § 4-5-103).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 5-103 (A.C.A. § 4-5-103)**

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

To define terms used in this Article (Chapter).

1. Paragraph (a) of subsection (1) (A.C.A. § 4-5-103(1)(a)) in defining a "credit" or "letter of credit" sets forth the requirement that the engagement of the bank or other person to honor drafts or other demands for payment be at the request of another and involve a transaction falling within the scope of this Article (Chapter) (Section 5-102 (A.C.A. § 4-5-102)). It then makes clear that the "engagement" may be by way of agreement, that is, a promise to honor, or by way of an authority to honor, thus including within the definition of letter of credit, papers called "authorities to purchase or pay". The definition also makes clear that the engagement may be either revocable or irrevocable, the legal consequences of which are spelled out in Section 5-106 (A.C.A. § 4-5-106) on the time and effect of establishment of a credit. Neither the definition nor any other section of this

Article (Chapter) deals with the issue of when a credit, not clearly labelled as either revocable or irrevocable falls within the one or the other category although the Code settles this issue with respect to the sales contract (Section 2-325 (A.C.A. § 4-2-325)). This issue so far as it affects an issuer under this Article (Chapter) is intentionally left to the courts for decision in light of the facts and general law (Section 1-103 (A.C.A. § 4-1-103)) with due regard to the general provisions of the Code in Article 1 (Chapter 1) particularly Section 1-205 (A.C.A. § 4-1-205) on course of dealing and usage of trade.

2. Paragraph (b) (A.C.A. § 4-5-103(1)(b)) is intended to show that the word "document" is far broader than "document of title" for the purposes of this Article (Chapter). This is of special importance with respect to the application of the Article (Chapter) to banks under Section 5-102(1)(a) (A.C.A. § 4-5-102(1)(a)) and differs from the definition of "document" in Article 9 (Chapter 9) on secured transactions which is there limited to documents of title. See Section 9-105(1)(e) (A.C.A. § 4-9-105(1)(e)).

3. The legal relations between the issuer (1)(c) (A.C.A. § 4-5-103(1)(c)) and the beneficiary (1)(d) (A.C.A. § 4-5-103(1)(d)) and between the issuer and the customer (1)(g) (A.C.A. § 4-5-103(1)(g)) are spelled out in other sections of this Article (Chapter). The legal relations between the customer and the beneficiary turn on the underlying transaction between them: if that transaction be one of sale of goods, their rights depend upon Article 2 (Chapter 2); if the transaction involves the sale of investment securities, Article 8 (Chapter 8) will be applicable; if the transaction involves the transfer of commercial paper, Article 3 (Chapter 3) will be applicable; if documents of title are transferred, Article 7 (Chapter 7) will be applicable; and if the transaction is intended to create a security interest, Article 9 (Chapter 9) will apply. The issuer is not a guarantor of the performance of these underlying transactions. See Section 5-109 (A.C.A. § 4-5-109).

4. The definition of customer in subsection (1)(g) (A.C.A. § 4-5-103(1)(g)) is explicitly made to include a bank which is acting for its customer, so that a particular transaction may well involve a metropolitan issuing bank and two customers, one of whom is the ultimate customer as, e.g., the buyer of goods and the other of whom is the buyer's local bank which has requested the metropolitan bank to issue the credit.

5. The definition of "advising" and "con-

firmer" banks in subsection (1)(e) (A.C.A. § 4-5-103(1)(e)) and (f) (A.C.A. § 4-5-103(1)(f)) do not include a statement of their legal consequences. These are set out primarily in Section 5-107 (A.C.A. § 4-5-107) on advice of credit; confirmation; error in statement.

*Cross References:*

Point 1: Sections 5-102 (A.C.A. § 4-5-102), 5-106 (A.C.A. § 4-5-106), 1-103 (A.C.A. § 4-1-103), 1-205 (A.C.A. § 4-1-205), 2-325 (A.C.A. § 4-2-325) and Article 1 (Chapter 1).

Point 2: Sections 5-102 (A.C.A. § 4-5-102), 1-201 (A.C.A. § 4-1-201) and 9-105 (A.C.A. § 4-9-105).

Point 3: Articles 2 (Chapter 2), 3 (Chapter 3), 7 (Chapter 7), 8 (Chapter 8), and 9 (Chapter 9); Section 5-109 (A.C.A. § 4-5-109).

Point 5: Section 5-107 (A.C.A. § 4-5-107).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Gives notification". Section 1-201 (A.C.A. § 4-1-201).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 5-104 (A.C.A. § 4-5-104)**

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-5-104(1)) is to make clear that, except for the statement or title required by Section 5-102(1)(c) (A.C.A. § 4-5-102(1)(c)) to bring certain transactions within the scope of this Article (Chapter), no particular form need be followed; it is sufficient that the credit is in writing and signed by the issuer. The subsection also states that any modification is subject to the same requirements of signing and writing. Compare Section 2-209(3) (A.C.A. § 4-2-209(3)) on sale of goods. Questions of mistake, waiver or estoppel are left to supple-

mentary principles of law. See Section 1-103 (A.C.A. § 4-1-103).

2. Subsection (2) (A.C.A. § 4-5-104(2)), although perhaps unnecessary in view of the definition of "signed" in Section 1-201 (A.C.A. § 4-1-201), is inserted here to make certain that code and authorized naming of an issuer is a sufficient signing. These forms of signing are so customary that their explicit inclusion is useful to eliminate all controversy on the point.

*Cross References:*

Point 1: Sections 5-102 (A.C.A. § 4-5-102), 2-209 (A.C.A. § 4-2-209), 1-103 (A.C.A. § 4-1-103).

Point 2: Section 1-201 (A.C.A. § 4-1-201).



*Definitional Cross References:*

"Confirming bank". Section 5-103 (A.C.A. § 4-5-103).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Issuer". Section 5-103 (A.C.A. § 4-5-103).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Telegram". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

### Comment to § 5-105 (A.C.A. § 4-5-105)

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

It is not to be expected that a financial institution will engage its credit without some form of expected remuneration. But it is not expected that the beneficiary will know what the issuer's remuneration was, or whether in fact there was any identifiable remuneration in a given case. And it

would be extraordinarily difficult for the beneficiary to prove the issuer's remuneration. This section dispenses with such proof.

*Definitional Cross References:*

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Terms". Section 1-201 (A.C.A. § 4-1-201).

### Comment to § 5-106 (A.C.A. § 4-5-106)

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

To define when a letter of credit is established in relation to the customer and the beneficiary, and to set forth for both irrevocable and revocable credits the legal consequences of the fact of establishment.

1. The primary purpose of determining the time of establishment of an irrevocable credit is to determine the point at which the issuer is no longer free to take unilateral action with respect to the cancellation of the credit or modification of its terms. So far as the customer is concerned this point of time is reached when the issuer "sends" (as that term is defined in Section 1-201 (A.C.A. § 4-1-201)) the credit or when its authorized agent, the advising bank, sends the advice of the credit to the beneficiary. Since the sending is pursuant to an agreement between the issuer and the customer, it is the issuer's performance of the first stage of the contract and under Section 5-107(4) (A.C.A. § 4-5-107(4)) the risk of transmission is on the customer. The beneficiary, however, cannot rely upon the credit until and unless he receives it. His right to protest to the issuer in the event of cancellation or

modification, therefore, turns on receipt. Nothing in this section affects the beneficiary's right to protest the improper nature of the credit or its cancellation (i.e., its non-receipt) as against the customer, who will normally have agreed to have a letter of credit issued in favor of the beneficiary under some underlying contract. See, e.g., Section 2-325(1) (A.C.A. § 4-2-325(1)) on buyer's failure to seasonably furnish an agreed letter of credit pursuant to a sales contract.

2. So far as a revocable letter of credit is concerned, the rules stated in subsections (3) (A.C.A. § 4-5-106(3)) and (4) (A.C.A. § 4-5-106(4)) are intended to show that so far as the customer or beneficiary are concerned establishment of such a credit has no legal significance unless the parties provide otherwise in their contracts with the issuer. The primary significance of the establishment of a revocable letter of credit is the obligation it imposes upon the issuer to innocent third parties who have negotiated or honored drafts drawn under the credit before receiving notice of its cancellation or change. The purpose of this rule is to further the movement of goods which the underlying transaction typically envisages and to preserve the solidity of American credits. As a necessary consequence of the imposition of

this duty upon the issuer, a duty of reimbursement of the issuer is placed upon the customer by explicit mention here even though it would fall within the general duty of reimbursement imposed by Section 5-114(3) (A.C.A. § 4-5-114(3)).

*Cross References:*

Point 1: Sections 5-107 (A.C.A. § 4-5-107), 2-325 (A.C.A. § 4-2-325).

Point 2: Section 5-114 (A.C.A. § 4-5-114).

*Definitional Cross References:*

"Beneficiary". Section 5-103 (A.C.A. § 4-5-103).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Customer". Section 5-103 (A.C.A. § 4-5-103).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 5-103 (A.C.A. § 4-5-103).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Receive notice". Section 1-201 (A.C.A. § 4-1-201).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 5-107 (A.C.A. § 4-5-107)**

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. An "advising bank" is defined in Section 5-103 (A.C.A. § 4-5-103). Subsection (1) of this section (A.C.A. § 4-5-107(1)) states its obligations to transmit accurately but not to honor drafts. The advice may of course not be accurate. The advising bank is responsible for its own error; under subsection (3) (A.C.A. § 4-5-107(3)), however, the issuer is bound to honor only in accordance with the original terms of the credit.

2. A "confirming bank" is defined in Section 5-103 (A.C.A. § 4-5-103). Subsection (2) of this section (A.C.A. § 4-5-107(2)) states its obligations and rights. The obligation, to the extent of the confirmation, is that of an issuer and so too is the right of reimbursement. The most important aspect of this rule is that a beneficiary who has received a confirmed credit has the independent engagements of both the issuer and the confirming bank. A confirming bank may of course be an advising bank so far as the issuer's engagement is concerned but this is rarely of importance because its own engagement if the terms be improperly advised

will be to honor in accordance with those terms.

3. Subsection (4) (A.C.A. § 4-5-107(4)) distributes the risks, as between customer and issuer, of errors in transmission and translation by placing them on the customer in the absence of specific agreement to the contrary. See also Section 5-109(1)(b) (A.C.A. § 4-5-109(1)(b)).

*Cross References:*

Sections 5-103 (A.C.A. § 4-5-103) and 5-109 (A.C.A. § 4-5-109).

*Definitional Cross References:*

"Advising bank". Section 5-103 (A.C.A. § 4-5-103).

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Confirming bank". Section 5-103 (A.C.A. § 4-5-103).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Customer". Section 5-103 (A.C.A. § 4-5-103).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 5-103 (A.C.A. § 4-5-103).



**Comment to § 5-108 (A.C.A. § 4-5-108)**

*Prior Uniform Statutory Provision:*  
None.

*Purposes:*

1. Practice has varied in regard to requiring notation on a letter of credit of the drafts drawn thereunder, and dispute has been rife for more than a century over the effect of failure by a purchaser to make such notations when they are required. The confusion has been due to a failure to distinguish two different types of credit and the different results which flow from each.

Under subsection (3) (A.C.A. § 4-5-108(3)), if an issuer chooses to issue a credit not requiring notation or if the credit is available in portions (see Section 5-110 (A.C.A. § 4-5-110)) without requirement of notation the issuer avoids all troubles attendant on any purchaser's failure to make notations, but he also imperils the utility of the credit to a beneficiary by reason of its possible exhaustion before any particular purchaser may have discounted drafts under it, so that there may be no market at all for such drafts. Yet this way of operation becomes useful and desirable at least whenever the credit is "domiciled," i.e., when it is explicitly made available only through one particular named correspondent, who will have his own records of prior drafts.

Subsection (3) (A.C.A. § 4-5-108(3)) expressly protects the issuer under such a credit (almost exactly as in the case of drafts drawn in a set under Section 3-801 (A.C.A. § 4-3-801)) in regard to any drafts which he honors in good faith, even though they are in the hands of a party who as against some other purchaser of drafts is not entitled to their proceeds. Similarly, in the last sentence, the rights of successive good faith purchasers are regulated as with drafts in a set.

2. Under subsection (2) (A.C.A. § 4-5-108(2)), on the other hand, the notation machinery is made available where the credit provides for notation in accordance with subsection (1) (A.C.A. § 4-5-108(1)).

This is useful particularly where the credit is intended (as a traveler's letter would be) for roving use, but the responsibility is put upon the purchaser to make the appropriate notation on pain of reimbursing the issuer for any loss occasioned by the failure. The provision in regard to delay of honor while evidence of notation is being procured is novel in the law, but is believed to be a necessary addition first, to protect the issuer, and second, to educate purchasers.

Subsection (2)(a) (A.C.A. § 4-5-108(2)(a)) avoids a difficult question of conflict of laws by making the obligation to note a condition of the credit itself, governed, therefore, by the law which controls the issue of the credit.

*Cross References:*

Sections 3-801 (A.C.A. § 4-3-801) and 5-110 (A.C.A. § 4-5-110).

*Definitional Cross References:*

"Beneficiary". Section 5-103 (A.C.A. § 4-5-103).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Customer". Section 5-103 (A.C.A. § 4-5-103).

"Document". Section 5-103 (A.C.A. § 4-5-103).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 5-103 (A.C.A. § 4-5-103).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

## Comment to § 5-109 (A.C.A. § 4-5-109)

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. The extent of the issuer's obligation to its customer is based upon the agreement between the two. Like all agreements within the Code, that agreement is the bargain of the parties in fact as defined in Section 1-201(3) (A.C.A. § 4-1-201(3)) and includes the obligation of good faith imposed by Section 1-203 (A.C.A. § 4-1-203) and the observance of any course of dealing or usage of trade made applicable by Section 1-205 (A.C.A. § 4-1-205). Subsection (1) of this section (A.C.A. § 4-5-109(1)) states, as a particular application of those general rules, the issuer's standard obligation of good faith and observance of general banking usage. Disclaimer of the obligation of good faith is governed by Section 1-102(3) (A.C.A. § 4-1-102(3)); conflict between express terms and a usage otherwise applicable is governed by Section 1-205(4) (A.C.A. § 4-1-205(4)).

Subsection (1) (A.C.A. § 4-5-109(1)) also clarifies the areas over which the issuer assumes no liability or responsibility except as the agreement of the parties may indicate the contrary. Paragraph (a) (A.C.A. § 4-5-109(1)(a)) rests on the assumptions that the issuer has had no control over the making of the underlying contract or over the selection of the beneficiary, and that the issuer receives compensation for a payment service rather than for a guaranty of performance. The customer will normally have direct recourse against the beneficiary if performance fails, whereas the issuer will have such recourse only by assignment of or in a proper case subrogation to the rights of the customer.

Paragraph (b) (A.C.A. § 4-5-109(1)(b)) also rests in part on the assumption that the issuer has not selected the other persons who may be involved in the transaction. Even though this assumption fails, however, as where the issuer selects the advising bank, the customer by entering the underlying transaction has assumed the risks inherent in it, including the risk of loss or destruction of the papers involved. The allocation of such risks between the parties to the underlying trans-

action is a proper subject for agreement between them, and the small charge for the issuance of a letter of credit ordinarily indicates that the issuer assumes minimum risks as against its customer. For comparable reasons Section 5-107(4) (A.C.A. § 4-5-107(4)) puts risks of transmission and translation upon the customer.

Paragraph (c) (A.C.A. § 4-5-109(1)(c)) again emphasizes that normally an issuer performs a banking and not a trade function. This paragraph makes an exception to Section 1-205(3) (A.C.A. § 4-1-205(3)), giving effect to usages of which the parties "are or should be aware." The comparable provision for nonbank issuers in subsection (3) of this section (A.C.A. § 4-5-109(3)) is limited to unknown banking usages and is thus merely a definition of a particular type of case not included by the words "should be aware" in Section 1-205(3) (A.C.A. § 4-1-205(3)).

2. Subsection (2) (A.C.A. § 4-5-109(2)) states the basic obligation of the issuer to examine with care the documents required under the credit. Under Section 1-102(3) (A.C.A. § 4-1-102(3)) this obligation cannot be disclaimed but standards of performance can be determined by agreement if not manifestly unreasonable. There are not infrequent cases in which both parties understand that peculiar circumstances make any check-up on some particular type of document impossible and it is agreed that the issuer may take it "as presented" — so e.g., export licenses in politically disturbed conditions, or "shipping documents" when no document in standard or regular form can be procured. These agreements will be controlling provided they are not manifestly unreasonable.

The purpose of the examination is to determine whether the documents appear regular on their face. The fact that the documents may be false or fraudulent or lacking in legal effect is not one for which the issuer is bound to examine. His duty is limited to apparent regularity on the face of the documents. The duties, privileges and rights of an issuer who has received documents which are regular on their face but are in fact improper because forged or fraudulent are dealt with in Section 5-114 (A.C.A. § 4-5-114).



*Cross References:*

Point 1: Sections 1-102 (A.C.A. § 4-1-102), 1-201 (A.C.A. § 4-1-201), 1-203 (A.C.A. § 4-1-203), 1-205 (A.C.A. § 4-1-205), 5-107 (A.C.A. § 4-5-107).

Point 2: Sections 1-102 (A.C.A. § 4-1-102), 5-114 (A.C.A. § 4-5-114).

*Definitional Cross References:*

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Beneficiary". Section 5-103 (A.C.A. § 4-5-103).

"Branch". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Customer". Section 5-103 (A.C.A. § 4-5-103).

"Document". Section 5-103 (A.C.A. § 4-5-103).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Genuine". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 5-103 (A.C.A. § 4-5-103).

"Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 5-110 (A.C.A. § 4-5-110)***Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. The beneficiary may desire to draw more than one draft under the credit, each draft accompanied, for instance, by documents evidencing a single shipment under the underlying sales contract. Subsection (1) (A.C.A. § 4-5-110(1)) makes clear that unless otherwise specified he may do so. Of course, if he does, each draft and its accompanying documents must satisfy the terms of the credit and their total must not exceed its amount. See comment to Section 5-108(3) (A.C.A. § 4-5-108(3)) on exhaustion of a credit on the rule governing the situation in which the total drafts drawn do total more than the maximum amount of the credit.

2. The entire purpose of the usual letter of credit transaction, from the customer's point of view, is to induce the beneficiary to deliver to him through the issuer the documents described in the credit. The buying customer wants the goods, and arranges the transaction in order to get the documents controlling the goods. Therefore, upon honor of the draft, the documents must be delivered free of claims even though the letter of credit is not for the full invoice price and any reservation of claim makes the draft non-

complying. A beneficiary who wishes to prevent such delivery must do so by agreement with the customer in the underlying contract and must treat the failure to provide a sufficient letter of credit as a breach of that contract (Section 2-325 (A.C.A. § 4-2-325)). So far as the issuer's duty of honor is concerned, the terms of the letter of credit are controlling and the rule of subsection (2) (A.C.A. § 4-5-110(2)) is applicable.

*Cross References:*

Point 1: Section 5-108 (A.C.A. § 4-5-108).

Point 2: Sections 2-325 (A.C.A. § 4-2-325), 5-114 (A.C.A. § 4-5-114).

*Definitional Cross References:*

"Beneficiary". Section 5-103 (A.C.A. § 4-5-103).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Document". Section 5-103 (A.C.A. § 4-5-103).

"Documentary draft". Section 5-103 (A.C.A. § 4-5-103).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 5-111 (A.C.A. § 4-5-111)***Prior Uniform Statutory Provision:*

None.

*Purpose:*

The purpose of this section is to state the peculiar warranty of performance made by a beneficiary and to make clear the intermediary character of the persons moving the documents from the beneficiary to the customer. The beneficiary's warranty of compliance with the conditions of the credit in subsection (1) (A.C.A. § 4-5-111(1)) is expressly extended to all interested parties unless agreed to the contrary. So far as the draft or the relevant documents are concerned, the beneficiary's warranties are usually those of an ordinary transferor or indorser for value although varying circumstances may alter this. The usual warranties of an intermediary, listed in subsection (2) (A.C.A. § 4-5-111(2)), are primarily its own good faith and authority. See also Comment to Section 5-114(2) (A.C.A. § 4-5-114(2)).

*Cross References:*

Sections 3-417 (A.C.A. § 4-3-417), 4-207

(A.C.A. § 4-4-207), 7-507 (A.C.A. § 4-7-507), 7-508 (A.C.A. § 4-7-508), 8-306 (A.C.A. § 4-8-306).

*Definitional Cross References:*

"Advising bank". Section 5-103 (A.C.A. § 4-5-103).

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Beneficiary". Section 5-103 (A.C.A. § 4-5-103).

"Collecting bank". Section 4-105 (A.C.A. § 4-4-105).

"Confirming bank". Section 5-103 (A.C.A. § 4-5-103).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Documentary draft". Section 5-103 (A.C.A. § 4-5-103).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Party". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 5-112 (A.C.A. § 4-5-112)***Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. A bank called on to honor drafts under a credit must examine the accompanying documents with care. See Section 5-109(2) (A.C.A. § 4-5-109(2)). That may take time. Subsection (1) of this section (A.C.A. § 4-5-112(1)) therefore allows a longer period than in the case of ordinary drafts (Section 3-506 (A.C.A. § 4-3-506)) for the decision. The language in the postamble to subsection (1) (A.C.A. § 4-5-112(1)) particularizes for letters of credit the general rule on what constitutes dishonor for negotiable instruments (Section 3-507 (A.C.A. § 4-3-507)) and makes it clear that not only the draft but the credit is dishonored. If the particular draft is for a portion of the credit only, its wrongful dishonor is anticipatory repudiation of the entire credit and the beneficiary may proceed under Section 5-115(2) (A.C.A. § 4-5-115(2)) as well as 5-115(1) (A.C.A. § 4-5-115(1)).

2. Many letters of credit involve transactions in international trade and include

as required documents the documents of title controlling the possession of goods on their way to the place of issuance of the credit. The ordinary rule requiring physical return of dishonored documentary drafts (Section 4-302 (A.C.A. § 4-4-302)) would therefore frequently work commercial hardship on the mercantile parties to the transaction; resale of the goods might be more difficult if the controlling documents of title were not available at the place of arrival of the goods. Subsection (2) (A.C.A. § 4-5-112(2)) therefore expressly permits the issuer to retain the documents as bailee for the presenter if it advises the presenter of its retention for that purpose. Compare Sections 4-202 (1)(b) (A.C.A. § 4-4-202(1)(b)), 4-503 (A.C.A. § 4-4-503) and 4-504 (A.C.A. § 4-4-504) on the duties of presenting banks.

3. The definition of "presenter" is to make clear that the term may include a bank which has rights in the documentary draft or which is in one sense the agent of the issuer. Such a bank may nevertheless give consent under subsection (1) (A.C.A. § 4-5-112(1)), and the advice authorized



in subsection (2) (A.C.A. § 4-5-112(2)) may be sent to it.

4. Insofar as the banks involved may also be depository, collecting or paying banks, Article 4 (Chapter 4) is applicable. Article 3 (Chapter 3) applies to the extent that a negotiable instrument is involved.

*Cross References:*

Point 1: Sections 3-506 (A.C.A. § 4-3-506), 3-507 (A.C.A. § 4-3-507), 5-109 (A.C.A. § 4-5-109), 5-114 (A.C.A. § 4-5-114) and 5-115 (A.C.A. § 4-5-115).

Point 2: Sections 4-202 (A.C.A. § 4-4-202), 4-302 (A.C.A. § 4-4-302), 4-503 (A.C.A. § 4-4-503) and 4-504 (A.C.A. § 4-4-504).

Point 4: Articles 3 (Chapter 3) and 4 (Chapter 4).

*Definitional Cross References:*

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Confirming bank". Section 5-103 (A.C.A. § 4-5-103).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Documentary draft". Section 5-103 (A.C.A. § 4-5-103).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 5-103 (A.C.A. § 4-5-103).

"Send". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 5-113 (A.C.A. § 4-5-113)**

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. A draft and accompanying documents may almost comply with the terms of the credit, but fail in some particular. The issuer is then not obligated to honor the draft, but it may be willing to do so if properly indemnified against the particular defect. Subsection (1) (A.C.A. § 4-5-113(1)) makes clear that it is proper for a bank seeking payment, acceptance, negotiation or reimbursement under the credit to give such indemnities, and that doing so is a proper part of the business of banking and therefore not ultra vires.

2. Subsection (2)(a) (A.C.A. § 4-5-113(2)(a)) limits the agreed indemnity to defects in the documents, since under Section 5-109(1)(a) (A.C.A. § 4-5-109 (1)(a)) the issuer is ordinarily not responsible for performance of the underlying transaction. The parties are free to agree further on the scope of the indemnity, but the agreement must be explicit, since an indemnity against defects in the goods would be most unusual.

3. Subsection (2)(b) (A.C.A. § 4-5-113(2)(b)) makes it clear that the indemnity in the absence of explicit agreement for a longer time continues for ten days after the receipt of the document by the ultimate customer, i.e., the customer who is a party to the underlying transaction. This ten day period may not be shortened.

If the customer fails to send notice of objection within the period, he loses his right to object and the need for the indemnity disappears. Compare Section 2-605(2) (A.C.A. § 4-2-605(2)). Thus indemnitors are free of the possibility of unknown long-continuing contingent liability, a danger under existing law.

4. The question whether a particular banking usage may require honor of documentary drafts accompanied by indemnities for particular defects goes to the meaning of the terms of the credit and is beyond the scope of this section. See, e.g., *Dixon, Irmaos & Cia, Ltd. v. Chase Nat. Bank of City of New York*, 144 F.2d 759 (2d Cir., 1944). If by virtue of indemnities and usage the credit is complied with, the rights of the customer rest on the implications of the usage rather than on breach of the issuer's duty under this Article (Chapter). Even so, the policy of this section and its terms require notice before the expiration date.

*Cross References:*

Point 2: Section 5-109 (A.C.A. § 4-5-109).

Point 3: Section 2-605 (A.C.A. § 4-2-605).

Point 4: Section 1-205 (A.C.A. § 4-1-205).

*Definitional Cross References:*

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Customer". Section 5-103 (A.C.A. § 4-5-103).

"Documents". Section 5-103 (A.C.A. § 4-5-103).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Midnight deadline". Section 4-104 (A.C.A. § 4-4-104).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Send". Section 1-201 (A.C.A. § 4-1-201).

### Comment to § 5-114 (A.C.A. § 4-5-114)\*

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

To define the areas in which the issuer must honor drafts or demands for payment under a credit and those in which he has an option to do so and to make explicit the customer's duty of reimbursement.

1. The letter of credit is essentially a contract between the issuer and the beneficiary and is recognized by this Article (Chapter) as independent of the underlying contract between the customer and the beneficiary (See Section 5-109 (A.C.A. § 4-5-109) and Comment thereto). In view of this independent nature of the letter of credit engagement, the issuer is under a duty to honor the drafts or demands for payment which in fact comply with the terms of the credit without reference to their compliance with the terms of the underlying contract. This is stated in subsection (1) (A.C.A. § 4-5-114(1)). Attempts by the issuer to reserve a right to dishonor by including a clause that all documents must be satisfactory to itself are declared invalid as essentially repugnant to an irrevocable letter of credit. Such a reservation can be made by issuing a revocable credit. See Section 5-106 (A.C.A. § 4-5-106). Particular documents, such as bills of lading or inspection or weight certificates can, of course, be required to be satisfactory to the issuer. The duty of the issuer to honor where there is factual compliance with the terms of the credit is also independent of any instructions from its customer once the credit has been issued and received by the beneficiary. (Section 5-106 (A.C.A. § 4-5-106)).

2. Documents, however, may appear regular on their face and apparently conforming to the credit whereas in fact they are forged or fraudulent or in other respects non-conforming to the warranties which arise under other Articles (Chap-

ters) of the Code on their transfer or negotiation. Since the issuer's duties to its customers are limited to examination of the documents with care (Section 5-109 (A.C.A. § 4-5-109)) and since it is important to preserve both the independent character of the issuer's engagement and the reasonable reliance on that engagement of persons dealing with papers regular on their face and in apparent compliance with the terms of the credit, subsection (2)(a) (A.C.A. § 4-5-114 (2)(a)) includes as an area in which the issuer's duty to honor exists cases in which persons have acted in a manner which would make them the equivalent of holders in due course under Article 3 (Chapter 3) or, where relevant, persons to whom documents have been duly negotiated under Article 7 (Chapter 7) or bona fide purchasers of securities under Article 8 (Chapter 8). The risk of the original bad-faith action of the beneficiary is thus thrown upon the customer who selected him rather than upon innocent third parties or the issuer. So, too, is the risk of fraud in the transaction placed upon the customer.

When, however, no innocent third parties as defined in subsection (a) (A.C.A. § 4-5-114(2)(a)) are involved the issuer is no longer under a duty to honor; but since these matters frequently involve situations in which the determination of the fact of the non-conformance may be difficult or time-consuming, the issuer if he acts in good faith is given the privilege of honoring the draft as against its customer, that is to say, with a right of reimbursement against him. The issuer may, however, refuse honor. In the event of honor, an action by the customer against the beneficiary will lie by virtue of either the underlying contract or Section 5-111(1) (A.C.A. § 4-5-111(1)) of this Article (Chapter). In the event of dishonor, if the presenter is a person who has parted with



value, he may also recover against the beneficiary under Section 5-111(1) (A.C.A. § 4-5-111(1)).

3. Subsection (3) (A.C.A. § 4-5-114(3)) represents the standard form for reimbursement. The words "duly honored" include not only situations where the issuer has honored because it was his duty to do so but also where he was privileged to do so as in subsection (2)(b) (A.C.A. § 4-5-114(2)(b)) or has done so as under Section 5-106(4) (A.C.A. § 4-5-106(4)).

*Cross References:*

Point 1: Sections 5-106 (A.C.A. § 4-5-106) and 5-109 (A.C.A. § 4-5-109).

Point 2: Sections 5-106 (A.C.A. § 4-5-106), 5-109 (A.C.A. § 4-5-109), 5-111 (A.C.A. § 4-5-111) and Articles 3 (Chapter 3), 7 (Chapter 7) and 8 (Chapter 8).

Point 3: Section 5-106 (A.C.A. § 4-5-106).

*Definitional Cross References:*

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Beneficiary". Section 5-103 (A.C.A. § 4-5-103).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Customer". Section 5-103 (A.C.A. § 4-5-103).

"Document". Section 5-103 (A.C.A. § 4-5-103).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 5-103 (A.C.A. § 4-5-103).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Receives notice". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Term". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 2, to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 5-115 (A.C.A. § 4-5-115)**

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-5-115(1)) states the rights of a person entitled to honor, both with respect to any documents and against the issuer, when there is wrongful dishonor. Whether dishonor is wrongful and whether a particular person is entitled to honor depend on the terms of the credit and on the provisions of this Article (Chapter), particularly Section 5-114 (A.C.A. § 4-5-114) on the issuer's duty to honor and Section 5-116 (A.C.A. § 4-5-116) on transfer and assignment.

2. Subsection (2) (A.C.A. § 4-5-115(2)) states the rights of the beneficiary upon repudiation of the credit, both against the issuer and with respect to any documents or goods. Note that wrongful dishonor of a draft for a portion of the credit is dishonor of the credit under Section 5-112(1) (A.C.A. § 4-5-112 (1)), and makes applica-

ble subsection (2) of this section (A.C.A. § 4-5-112(2)) as well as subsection (1) (A.C.A. § 4-5-112(1)).

3. Both subsections are limited to irrevocable credits. Since under Section 5-106(3) (A.C.A. § 4-5-106(3)) revocable credits may be modified or revoked without notice to the customer or the beneficiary, rights against the issuer like those here provided can hardly arise under them. The rights of innocent third persons under revocable credits are governed by Section 5-106(4) (A.C.A. § 4-5-106(4)) rather than by this section.

*Cross References:*

Point 1: Sections 2-707 (A.C.A. § 4-2-707), 2-710 (A.C.A. § 4-2-710), 5-114 (A.C.A. § 4-5-114) and 5-116 (A.C.A. § 4-5-116).

Point 2: Sections 2-610 (A.C.A. § 4-2-610), 2-611 (A.C.A. § 4-2-611), 2-703 (A.C.A. § 4-2-703) through 2-706 (A.C.A. § 4-2-706), and 5-112 (A.C.A. § 4-5-112).

Point 3: Section 5-106 (A.C.A. § 4-5-106).

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Beneficiary". Section 5-103 (A.C.A. § 4-5-103).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Document". Section 5-103 (A.C.A. § 4-5-103).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Issuer". Section 5-103 (A.C.A. § 4-5-103).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

**1972 Official Comment to § 5-116 (A.C.A. § 4-5-116)\***

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. The situation involved is typified by that of an exporter who has made a contract for sale with a foreign buyer and is beneficiary of a letter of credit initiated by the buyer, especially where the subject matter involves goods still to be manufactured. The exporter is frequently in need of the wherewithal not only to finance payment to his supplier but to assure the latter against cancellation of the order during the process of manufacture. For this purpose assignment of the exporter's rights under the letter of credit is frequently desirable.

Since, however, there is a general confusion of thought as to the meaning of "assignment or transfer of a credit," the law remains uncertain. If "assignment of the credit" includes delegation of performance of the conditions under the credit then the initiating customer, who in many cases has put his faith in performance or supervision of performance by a beneficiary of established reputation, may be deprived of real and intended security. See Comment to Section 2-210 (A.C.A. § 4-2-210) on the comparable situation as to the sales contract. On the other hand, all "negotiation credits" involve a transfer of the rights of the beneficiary by way of negotiation of the draft and such transfer involves no important loss of the initiating party's intended safety. Meanwhile, the exceedingly useful institution of "back to back" credits, in which an American bank issues a credit with the exporter as the initiating customer and the exporter's supplier as the beneficiary is dangerous for the banker unless he can secure in

advance an effective assignment from the exporter of the latter's rights under the initial credit issued on behalf of his foreign buyer. Against this background, the section is drawn.

2. Subsection (1) (A.C.A. § 4-5-116(1)) requires the beneficiary's signature on drafts drawn under the credit unless it is expressly designated as assignable or transferable. If it is so designated, the normal rules of assignment apply and both the right to draw and the performance of the beneficiary can be transferred, subject to the beneficiary's continuing liability, if any, for the nature of the performance.

3. Subsection (2) (A.C.A. § 4-5-116(2)) makes clear that to safeguard among other things the letter of credit "back to back" practice, the assignability of proceeds in advance of performance cannot be prohibited in advance of performance. In this respect the letter of credit is treated like any other contract calling for money to be earned. See Section 9-318 (A.C.A. § 4-9-318) generally and Section 2-210 (A.C.A. § 4-2-210) as to sales contracts. But the special nature of the letter of credit as evidence of the right to proceeds is recognized by the additional requirement of delivery of the letter to the assignee as a condition precedent to the perfection of the assignment. Similarly, the fact that letters of credit normally require presentation of drafts or demands for payment which are drawn under it and that as a result notice of assignment of proceeds can exist simultaneously with a draft payable by order or indorsement to either the beneficiary or another third person leads to the necessity for permitting an issuer to protect itself against double payment by requiring exhibition of the letter or advice of credit.



4. Subsection (3) (A.C.A. § 4-5-116(3)) makes clear that the section has no application to the normal case of negotiation of a draft or the transfer of a demand for payment unless effective assignment under the section has taken place.

*Cross References:*

Point 1: Section 2-210 (A.C.A. § 4-2-210).

Point 3: Sections 2-210 (A.C.A. § 4-2-210) and 9-318 (A.C.A. § 4-9-318) and Article 9 (Chapter 9).

*Definitional Cross References:*

"Accept". Section 3-410 (A.C.A. § 4-3-410).

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Beneficiary". Section 5-103 (A.C.A. § 4-5-103).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 5-103 (A.C.A. § 4-5-103).

"Receive notification". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 4, to incorporate the 1972 changes to this Uniform Commercial Code section.

**Comment to § 5-117 (A.C.A. § 4-5-117)**

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

A bank which issues a letter of credit acts as a principal, not as agent for its customer, and engages its own credit. But the resulting liability is not like that to its depositors, and the security and indemnity furnished by the customer against it and the documents which it receives on honor of complying drafts are not like its own investments.

The typical letter of credit transaction facilitates the movement of goods. The bank's credit is engaged, but it expects to be put in funds by its customer before it makes disbursements, or to be reimbursed immediately afterwards. And everybody understands that the documents received upon honor of complying drafts are to be turned over to the customer at once when he makes reimbursement or signs trust receipts. Only the bank's commission, if the transaction is completed, will enter the bank's general assets and join the other backing of its deposit liabilities.

It is therefore proper, when insolvency occurs before the letter of credit transaction is completed, to regard both the outstanding liabilities, the security held and funds provided to indemnify against those liabilities, and the related drafts and documents, as separate from deposit liabilities and from general assets, and to deal with them as separate. To do so carries out

the original purpose, which is to facilitate the underlying mercantile transaction, and does no wrong to the bank's depositors and other general creditors.

This section states appropriate rules to carry out these principles. The section is limited to transactions under Section 5-102(1)(a) (A.C.A. § 4-5-102(1)(a)) and (b) (A.C.A. § 4-5-102(1)(b)) to prevent abuse in situations where the commercial purpose of facilitating the movement of goods, securities or the like may be lacking.

*Cross Reference:*

Compare Section 4-214 (A.C.A. § 4-4-214), and the Comment thereto.

*Definitional Cross References:*

"Advising Bank". Section 5-102 (A.C.A. § 4-5-102).

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Beneficiary". Section 5-103 (A.C.A. § 4-5-103).

"Confirming Bank". Section 5-103 (A.C.A. § 4-5-103).

"Credit". Section 5-103 (A.C.A. § 4-5-103).

"Customer". Section 5-103 (A.C.A. § 4-5-103).

"Document". Section 5-103 (A.C.A. § 4-5-103).

"Draft". Section 3-104 (A.C.A. § 4-3-104).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Insolvent". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 5-103 (A.C.A. § 4-5-103).

"Person". Section 1-201 (A.C.A. § 4-1-201).



## ARTICLE 6

### (A.C.A. § 4-6-101 ET SEQ.)\*

**A.C.R.C. Notes.** Acts 1991, No. 344, § 4, provided: "Rights and obligations that arose under Chapter 6, Title 4, Arkansas Code Annotated, "BULK TRANSFERS" and 4-9-111 before the effective date of this act repealing same, remain valid and may be enforced as though those provisions had not been repealed."

Although the Acts 1991, No. 344 apparently was intended to repeal § 4-9-111 as well as this chapter, the repeal of § 4-9-111 was not given effect by that act.

\*Article 6 (A.C.A. § 4-6-101 et seq.) was repealed by Acts 1991, No. 344, § 1.

### Comment to § 6-101 (A.C.A. § 4-6-101)

*Prior Uniform Statutory Provision:*  
None.

*Purposes:*

1. This Article (Chapter) attempts to simplify and make uniform the bulk sales law of the states that adopt this Act.

2. Many states have bulk sales laws, of varying type and coverage. Their central purpose is to deal with two common forms of commercial fraud, namely:

(a) The merchant, owing debts, who sells out his stock in trade to a friend for less than it is worth, pays his creditors less than he owes them, and hopes to come back into the business through the back door some time in the future.

(b) The merchant, owing debts, who sells out his stock in trade to any one for any price, pockets the proceeds, and disappears leaving his creditors unpaid.

3. The first is one form of fraudulent conveyance. The substantive law concerning it has been codified by the Commissioners in the Uniform Fraudulent Conveyance Act. No change in that Act is proposed. The contribution of the bulk sales laws to the problem is in the requirement that creditors receive advance notice of bulk sales. Having such notice, they can investigate the price and other circumstances of the sale before it occurs, and determine then instead of later whether they should try to stop it. This is a valuable policing measure, and is continued. To be effective, it requires a longer notice than five days. This Article (Chapter) therefore follows in this respect those laws which require a longer notice (Sections 6-105 (A.C.A. § 4-6-105) and 6-108 (A.C.A. § 4-6-108)).

4. The second form of fraud suggested above represents the major bulk sales risk, and its prevention is the central purpose of the existing bulk sales laws and of this Article (Chapter). Advance notice to the seller's creditors of the impending sale is an important protection against it, since with notice the creditors can take steps to impound the proceeds if they think it necessary. In many states, typified for instance by New York, such notice is substantially the only protection which bulk sales statutes give. Other states, typified for instance by Pennsylvania, give additional protection by imposing on the buyer an obligation to ensure that the money that he pays to his indebted seller is in fact applied to pay the seller's debts. This Article (Chapter) requires notice to creditors (Section 6-105 (A.C.A. § 4-6-105)) and if bracketed Section 6-106 (A.C.A. § 4-6-106) is enacted [not adopted in Arkansas]\* it imposes the other obligation also.

5. These are the affirmative reasons for a law such as this Article (Chapter). The objections are chiefly delay and red tape, on legitimate transactions, and the possibility of a trap for the unwary buyer. It is hard to avoid the latter danger. But to minimize both it and the former the transactions subject to the Article (Chapter) are identified as clearly as possible and are limited to those which carry the dangers to be guarded against (Sections 6-102 (A.C.A. § 4-6-102) and 6-103 (A.C.A. § 4-6-103)), and the sanctions are such as to permit honest and solvent buyers and sellers to put through transactions promptly without undue risk. Sections

6-104 (A.C.A. § 4-6-104) through 6-108 (A.C.A. § 4-6-108).

*Cross References:*

Point 3: Sections 6-105 (A.C.A. § 4-6-105) and 6-108 (A.C.A. § 4-6-108).

Point 4: Sections 6-105 (A.C.A. § 4-6-105) and 6-106 (A.C.A. § 4-6-106) [reserved].

Point 5: Sections 6-102 (A.C.A. § 4-6-

102), 6-103 (A.C.A. § 4-6-103), 6-104 (A.C.A. § 4-6-104) through 6-108 (A.C.A. § 4-6-108)).

\*Bracketed language inserted by the compiler of the Arkansas Statutes of 1947 Annotated.

**Comment to § 6-102 (A.C.A. § 4-6-102)**

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. Much of the litigation under the existing laws has dealt with the kinds of businesses and the kinds of transfers covered. This section defines these matters.

2. The businesses covered are defined in subsection (3) (A.C.A. § 4-6-102(3)). Notice that they do not include farming nor contracting nor professional services, nor such things as cleaning shops, barber shops, pool halls, hotels, restaurants, and the like whose principal business is the sale not of merchandise but of services. While some bulk sales risk exists in the excluded businesses, they have in common the fact that unsecured credit is not commonly extended on the faith of a stock of merchandise.

3. The transfers included are of "mate-

rials, supplies, merchandise or other inventory" that is, of goods. Transfers of investment securities are not covered by the Article (Chapter), nor are transfers of money, accounts receivable, chattel paper, contract rights, negotiable instruments, nor things in action generally. Such transfers are dealt with in other Articles (Chapters), and are not believed to carry any major bulk sales risk.

4. The kinds of transfers covered are identified in paragraph (1). They are believed to be those that carry the major bulk sales risks. They are further limited by the section following.

*Cross References:*

Point 3: Articles 3, 4, 8 and 9 (Chapters 3, 4, 8 and 9).

Point 4: Section 6-103 (A.C.A. § 4-6-103).

**Comment to § 6-103 (A.C.A. § 4-6-103)\***

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. The section defines the transfers which although within the general definition of the previous section ought not to be subjected to the requirements of this Article (Chapter).

2. Some of the existing Bulk Sales laws cover "bulk mortgages" as well as outright sales. In this Code security interests of all kinds in personal property are regulated by Article 9 (Chapter 9), Secured Transactions. Subsection (1) of this section (A.C.A. § 4-6-103(1)) therefore excludes all transfers for security from the operation of this Article (Chapter). See also Sec. 9-111 (A.C.A. § 4-9-111).

3. The exclusions described in subsections (2) (A.C.A. § 4-6-103(2)), (3) (A.C.A.

§ 4-6-103(3)), (4) (A.C.A. § 4-6-103(4)), (5) (A.C.A. § 4-6-103(5)) and (8) (A.C.A. § 4-6-103(8)) are believed to explain themselves.

4. Subsection (6) (A.C.A. § 4-6-103(6)) will exclude a great many transactions from the requirements of this Article (Chapter). It is believed the exclusion is justified, and that it removes many of the objections to a law of this character. The transactions excluded are outright sales, since that is the only kind of a transaction in which the transferee is likely to bind himself to pay the transferor's debts. The purpose of this Article (Chapter) on outright sales is to give the seller's creditors a reasonable chance to collect their debts. (See Sections 6-104 (A.C.A. § 4-6-104) through 6-108 (A.C.A. § 4-6-108)). If the buyer is willing to assume personal liabil-



ity of those debts, and is himself solvent after such assumption, there is no reason to subject the transaction to the delay and red tape which this Article (Chapter) imposes.

5. Subsection (7) (A.C.A. § 4-6-103(7)) deals with certain changes in the ownership of a business, as by incorporation, change of membership of a firm, or transfer from a sole proprietor to a firm. The exclusion is believed to be justified within the limits stated in the subsection. Notice that in all the transactions to which the subsection applies (a) both the original debtor and the new enterprise are personally bound to pay the debts, (b) the property subject to the debts before the transfer is still subject to them, and (c) the original debtor has taken nothing out of the transaction except an interest (shares in a corporation, an interest in a firm, or a subordinated obligation) which is junior to the debts.

#### **Comment to § 6-104 (A.C.A. § 4-6-104)\***

##### *Prior Uniform Statutory Provision:*

None.

##### *Purposes:*

1. The section describes the information that must be compiled and kept available to creditors on all bulk transfers subject to this Article (Chapter) except those made by sale at auction. Additional requirements for particular kinds of transfers are stated in the succeeding Sections 6-105 (A.C.A. § 4-6-105) through 6-107 (A.C.A. § 4-6-107). The section on auction sales (Section 6-108 (A.C.A. § 4-6-108)) imposes similar requirements, but on different people and with a different sanction.

2. Except for the accuracy of the list of creditors, the sanction for noncompliance with the present section is that the transfer is ineffective against creditors of the transferor. The creditors referred to are those holding claims based on transactions or events occurring before the transfer. (Section 6-109 (A.C.A. § 4-6-109)). Any such creditor or creditors may therefore disregard the transfer and levy on the goods as still belonging to the transferor, or a receiver representing them can take them by whatever procedure the local law provides. But it follows also that if the debts of the transferor are paid as they

##### *Cross References:*

Point 1: Section 6-102 (A.C.A. § 4-6-102).

Point 2: Section 9-111 (A.C.A. § 4-9-111) and Chapter 9 generally.

Point 4: Sections 6-104 (A.C.A. § 4-6-104) through 6-108 (A.C.A. § 4-6-108).

##### *Definitional Cross References:*

"Creditor". Sections 1-201 (A.C.A. § 4-1-201) and 6-109 (A.C.A. § 4-6-109).

"Person". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 19 (6-103), to add the last paragraph of the section, which was added by the 1962 changes to this Uniform Commercial Code section.

mature disregard of the requirements of the section creates no liability. And a defect can always be cured by paying off the unpaid creditors.

3. The sanction for the accuracy of the list of creditors is the criminal law of the state relative to false swearing, made applicable by subsection (2) (A.C.A. § 4-6-104(2)).

##### *Cross References:*

Point 1: Sections 6-105 (A.C.A. § 4-6-105) through 6-108 (A.C.A. § 4-6-108).

Point 2: Section 6-109 (A.C.A. § 4-6-109).

##### *Definitional Cross References:*

"Bulk transfer". Section 6-102 (A.C.A. § 4-6-102).

"Creditor". Sections 1-201 (A.C.A. § 4-1-201) and 6-109 (A.C.A. § 4-6-109).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 308, § 19 (6-104), to incorporate the 1962 changes to this Uniform Commercial Code section.

**Comment to § 6-105 (A.C.A. § 4-6-105)**

*Prior Uniform Statutory Provision:*  
None.

*Purposes:*

1. This section is the heart of the Article (Chapter). It requires notice to creditors of all bulk transfers subject to the Article (Chapter), except those made by auction sale. The contents of the notice, the persons to whom it must be given, and the manner of giving it are stated in Section 6-107 (A.C.A. § 4-6-107). The section on auction sales (6-108 (A.C.A. § 4-6-108)) also calls for notice but by a different person and with a different sanction.

2. The notice in all cases must be given ten days in advance. See Points 3 and 4 to Section 6-101 (A.C.A. § 4-6-101).

3. The sanction for noncompliance with the section is that the transfer is ineffective against creditors. Comment 2 to Section 6-104 (A.C.A. § 4-6-104) applies.

*Cross References:*

Point 1: Sections 6-107 (A.C.A. § 4-6-107) and 6-108 (A.C.A. § 4-6-108).

Point 2: Points 3 and 4 to Section 6-101 (A.C.A. § 4-6-101).

Point 3: Comment 2 to Section 6-104 (A.C.A. § 4-6-104).

*Definitional Cross References:*

"Bulk transfer". Section 6-102 (A.C.A. § 4-6-102).

"Creditor". Sections 1-201 (A.C.A. § 4-1-201) and 6-109 (A.C.A. § 4-6-109).

**Comment to § 6-106 (A.C.A. § 4-6-106 [Reserved.])\***

*Prior Uniform Statutory Provision:*  
None.

*Purposes:*

1. This section applies only to transfers "for which new consideration becomes payable". It applies only if something, which of course need not be money becomes payable in consideration of the transfer. The purpose of this section is to give the transferor's creditors direct protection against improper dissipation by the transferor of the consideration which he receives for the transfer. See Comment 4 to Section 6-101 (A.C.A. § 4-6-101).

2. Subsections (6) and (7) of Section 6-103 (A.C.A. § 4-6-103(6) and (7)) remove many outright transfers from the operation of this Article (Chapter) and therefore of course of this section (A.C.A. § 4-6-106). In addition it is clear from the section itself that in any case in which the seller's debts are to be paid as they mature the buyer can disregard the section without danger of added liability except that his seller will disappoint him. And in case of trouble the buyer is entitled under Section 6-109(2) (A.C.A. § 4-6-109(2)) to credit for sums honestly paid to particular creditors.

3. The methods by which the buyer may perform the duty stated in the section are various. He may, for instance, by agreement with the seller hold the consideration in his own hands until the debts

are ascertained, or deposit it in an account subject to checks bearing his counter-signature, or deposit it in escrow with an independent agency. If the affairs of the seller are so involved that nothing else is practical the buyer will no doubt pay the consideration into the registry of an appropriate court and interplead the seller's creditors. If optional subsection (4) (A.C.A. § 4-6-106(4)) is enacted, specific provision is made for such a procedure. But notice that the obligation runs, not to all possible creditors of the transferor who may appear at any time in the future, but only to existing creditors whom the transferee has a chance to identify in one of the ways provided in subsection (1) (A.C.A. § 4-6-106(1)). [This paragraph was amended in 1962].

*Cross References:*

Point 1: Section 6-108 (A.C.A. § 4-6-108), Comment 4 to Section 6-101 (A.C.A. § 4-6-101).

Point 2: Sections 6-103(6) and (7) (A.C.A. § 4-6-103(6) and (7)), 6-109(2) (A.C.A. § 4-6-109(2)).

Point 3: Section 6-109 (A.C.A. § 4-6-109).

*Definitional Cross References:*

"Bulk transfer". Section 6-102 (A.C.A. § 4-6-102).

"Creditor". Section 6-109 (A.C.A. § 4-6-109).



"Writing". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was not adopted in Arkansas.

### Comment to § 6-107 (A.C.A. § 4-6-107)\*

*Prior Uniform Statutory Provision:*  
None.

*Purposes:*

1. This section specifies the contents of the notice to be given on all the transfers covered by Section 6-105 (A.C.A. § 4-6-105) (that is, all transfers subject to the Article (Chapter) except those made by auction sale) and the manner in which it is to be given.

2. Under the section, if the debts of the transferor are to be paid in full as they fall due, a short form of notice is provided. This facilitates honest and solvent transactions.

3. If the transfer is by auction sale Section 6-108 (A.C.A. § 4-6-108) applies.

4. Subsection (2)(e) (A.C.A. § 4-6-107(2)(e)) is a corollary of Section 6-106 (A.C.A. § 4-6-106) and should be omitted if that section is. See note to Section 6-106 (A.C.A. § 4-6-106).

*Cross References:*

Point 1: Section 6-105 (A.C.A. § 4-6-105).

Point 3: Section 6-108 (A.C.A. § 4-6-108).

Point 4: Note to Section 6-106 (A.C.A. § 4-6-106).

*Definitional Cross References:*

"Bulk transfer". Section 6-102 (A.C.A. § 4-6-102).

"Creditor". Sections 1-201 (A.C.A. § 4-1-201) and 6-109 (A.C.A. § 4-6-109).

"Person". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 19 (6-107) to incorporate the 1962 changes to this Uniform Commercial Code section and for renumbering to conform to the Uniform Commercial Code section.

### Comment to § 6-108 (A.C.A. § 4-6-108)\*

*Prior Uniform Statutory Provision:*  
None.

*Purposes:*

1. The section is intended to make appropriate application of the requirements of this Article (Chapter) to auction sales. It is clear that the provisions of the four previous sections in their literal form cannot be applied directly to an auction, since neither the price nor the identity of the purchaser or purchasers can be known until the sale occurs. But it is equally clear that if auctions were excluded entirely from the transfers covered by this Article (Chapter) the way would be open to a debtor to carry out a bulk transfer of his property without notice to his creditors and without any duty upon anyone to see the application of the proceeds. The section attempts to meet this situation by imposing the obligations stated in the section upon the persons there described.

2. Since the obligation to give advance

notice, etc., cannot rest upon bidders at an auction it is clear that the sale must be effective so far as they are concerned whether or not the section is complied with. Subsection (4) (A.C.A. § 4-6-107(4)) therefore states a sanction which does not affect the purchasers. Notice that the sanction applies only "if the auctioneer knows that the auction constitutes a bulk transfer." No doubt in some cases, as for instance when goods are simply received on consignment for sale, he may not know.

3. Subsection (3)(c) (A.C.A. § 4-6-108(3)(c)) is a corollary of Section 6-106 (A.C.A. § 4-6-106) and should be omitted if that section is. See note to that section.

*Cross References:*

Point 1: Sections 6-104 (A.C.A. § 4-6-104) through 6-107 (A.C.A. § 4-6-107).

Point 2: Sections 6-104 (A.C.A. § 4-6-104) through 6-107 (A.C.A. § 4-6-107).

Point 3: Section 6-106 (A.C.A. § 4-6-106) and Note thereto.

*Definitional Cross References:*

"Bulk transfer". Section 6-102 (A.C.A. § 4-6-102).

"Creditor". Sections 1-201 (A.C.A. § 4-1-201) and 6-109 (A.C.A. § 4-6-109).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 6-109 (A.C.A. § 4-6-109)\****Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-6-109(1)) identifies the creditors who may have rights under the various provisions of this Article (Chapter). The claims referred to of course include unliquidated claims.

2. Subsection (2) (A.C.A. § 4-6-109(2)) gives the transferee or auctioneer appropriate credit for honest payments to particular creditors. If Section 6-106 (A.C.A. § 4-6-106) is omitted this subsection should be also. See note to that section.

*Cross References:*

Point 1: Sections 6-104 (A.C.A. § 4-6-104) through 6-108 (A.C.A. § 4-6-108).

**Comment to § 6-110 (A.C.A. § 4-6-110)\****Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. The section deals with subsequent transfers by the transferee.

2. The second transfer may of course itself be a "bulk transfer" subject to this Article (Chapter). Whether it is or not will depend on its own character under Sections 6-102 (A.C.A. § 4-6-102) and 6-103 (A.C.A. § 4-6-103).

*Cross References:*

Point 2: Sections 6-102 (A.C.A. § 4-6-102) and 6-103 (A.C.A. § 4-6-103).

*Definitional Cross References:*

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 19 (6-108) to incorporate the 1962 changes to this Uniform Commercial Code section and for renumbering to conform it to the Uniform Commercial Code section.

Point 2: Section 6-106 (A.C.A. § 4-6-106) and Comment thereto.

*Definitional Cross References:*

"Auctioneer". Section 6-108 (A.C.A. § 4-6-108).

"Bulk transfer". Section 6-102 (A.C.A. § 4-6-102).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 19 (6-108) for renumbering to conform section numbers to the Uniform Commercial Code section.

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 19 (6-110) to incorporate the 1962 changes to this Uniform Commercial Code section and for renumbering to conform to the Uniform Commercial Code section.



**Comment to § 6-111 (A.C.A. § 4-6-111)\****Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. This Article (Chapter) imposes unusual obligations on buyers of property. A short statute of limitations is therefore appropriate.

2. The main sanction for noncompliance with the Article (Chapter) is that the transfer "is ineffective against any creditor of the transferor." Sections 6-104 (A.C.A. § 4-6-104), 6-105 (A.C.A. § 4-6-105). This means, e.g., that a judgment creditor of the transferor may levy execution on the property. See Comment 2 to Section 6-104 (A.C.A. § 4-6-104).

In such a case, which may be expected to be frequent, no "action under this Article (Chapter)" will be necessary. The action will have been brought and prosecuted to judgment on whatever the claim was. The only thing done "under this Article (Chapter)" will be the levy and resulting sale.

The short statute of limitations is therefore made applicable to levies as well as actions. "Levy", which is not a defined term in the Code, should be read broadly as including not only levies of execution proper but also attachment, garnishment, trustee process, receivership, or whatever proceeding, under the state's practice, is used to apply a debtor's property to payment of his debts.

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 19 (6-107) to incorporate the 1962 changes to this Uniform Commercial Code section and for renumbering to conform to the Uniform Commercial Code section.

**ARTICLE 7**  
**(A.C.A. § 4-7-101 ET SEQ.)**

**Comment to § 7-101 (A.C.A. § 4-7-101)**

This Article (Chapter) is a consolidation and revision of the Uniform Warehouse Receipts Act and the Uniform Bills of Lading Act, and embraces also the provisions of the Uniform Sales Act relating to negotiation of documents of title.

The only substantial omissions of material covered in the previous uniform acts are the criminal provisions found in the Warehouse Receipts and Bills of Lading acts. These criminal provisions are inappropriate to a Commercial Code, and for the most part duplicate portions of the ordinary criminal law relating to frauds.

The Article (Chapter) does not attempt to define the tort liability of bailees, except to hold certain classes of bailees to a minimum standard of reasonable care. For important classes of bailees, liabilities in case of loss, damages or destruction, as well as other legal questions associated with particular documents of title, are governed by federal statutes, international treaties, and in some cases regulatory state laws, which supersede the provisions of this Article (Chapter) in case of inconsistency. See Section 7-103 (A.C.A. § 4-7-103).

**Comment to § 7-102 (A.C.A. § 4-7-102)**

*Prior Uniform Statutory Provision:*

Section 76, Uniform Sales Act; Section 58, Uniform Warehouse Receipts Act; Sections 1 and 53, Uniform Bills of Lading Act.

*Changes:*

Applicable definitions from the uniform acts have been consolidated and revised; definition of delivery order is new.

*Purposes of Changes and New Matter:*

1. "Bailee" was not defined in the old uniform acts. It is used in this Article (Chapter) as a blanket term to designate carriers, warehousemen and others who normally issue documents of title on the basis of goods which they have received. The definition does not, however, require actual possession of the goods. If a bailee acknowledges possession when he does not have it he is bound by sections of this Article (Chapter) which declare the "bailee's" obligations. (See definition of "Issuer" in this section and Sections 7-203 (A.C.A. § 4-7-203) and 7-301 (A.C.A. § 4-7-301) on liability in case of non-receipt.)

2. The definition of warehouse receipt contained in the general definitions section of this Act (Section 1-201 (A.C.A. § 4-1-201)) eliminates the requirement of the Uniform Warehouse Receipts Act that the issuing warehouseman be "lawfully engaged" in business. The warehouseman's compliance with applicable state regulations such as the filing of a bond has

no bearing on the substantive issues dealt with in this Article (Chapter). Certainly the issuer's violations of law should not diminish his responsibility on documents he has put in commercial circulation. The Uniform Warehouse Receipts Act requirement that the warehouseman be engaged "for profit" has also been eliminated in view of the existence of state operated and co-operative warehouses. But it is still essential that the business be storing goods "for-hire" (Section 1-201 (A.C.A. § 4-1-201) and this section). A person does not become a warehouseman by storing his own goods.

3. Delivery orders, which were included without qualification in the Uniform Sales Act definition of document of title, must be treated differently in this consolidation of provisions from the three uniform acts. When a delivery order has been accepted by the bailee it is for practical purposes indistinguishable from a warehouse receipt. Prior to such acceptance there is no basis for imposing obligations on the bailee other than the ordinary obligation of contract which the bailee may have assumed to the depositor of the goods.

*Cross References:*

Point 1: Sections 7-203 (A.C.A. § 4-7-203) and 7-301 (A.C.A. § 4-7-301).

Point 2: Sections 1-201 (A.C.A. § 4-1-201) and 7-203 (A.C.A. § 4-7-203).

See general comment to document of title in Section 1-201 (A.C.A. § 4-1-201).



*Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-103 (A.C.A. § 4-7-103)***Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. To make clear what would of course be true without the Section, that applicable Federal law is paramount.

2. To make clear also that regulatory state statutes (such as those fixing or authorizing a commission to fix rates and prescribe services, authorizing different charges for goods of different values, and limiting liability for loss to the declared value on which the charge was based) are not affected by the Article (Chapter) and are controlling on the matters which they

cover. Notice that the reference is not only to such statutes, but to tariffs, classifications and regulations filed or issued pursuant to them.

*Cross References:*

Sections 7-201 (A.C.A. § 4-7-201), 7-202 (A.C.A. § 4-7-202), 7-204 (A.C.A. § 4-7-204), 7-206 (A.C.A. § 4-7-206), 7-309 (A.C.A. § 4-7-309), 7-401 (A.C.A. § 4-7-401), 7-403 (A.C.A. § 4-7-403).

*Definitional Cross Reference:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-104 (A.C.A. § 4-7-104)***Prior Uniform Statutory Provision:*

Sections 27 and 76, Uniform Sales Act; Sections 2, 3, 4 and 5, Uniform Warehouse Receipts Act; Sections 2, 3, 4, 5 and 53, Uniform Bills of Lading Act.

*Changes:*

Consolidated and rewritten.

*Purposes of Changes:*

This Article (Chapter) deals with a class of commercial paper representing commodities in storage or transportation. This "commodity paper" is to be distinguished from what might be called "money paper" dealt with in the Article (Chapter) of this Act on Commercial Paper (Article 3 (Chapter 3)) and "investment paper" dealt with in the Article (Chapter) of this Act on Investment Securities (Article 8 (Chapter 8)). The class of "commodity paper" is designated "document of title" following the terminology of the Uniform

Sales Act Section 76. Section 1-201 (A.C.A. § 4-1-201). The distinctions between negotiable and nonnegotiable documents in this section makes the most important subclassification employed in the Article (Chapter), in that the holder of negotiable documents may acquire more rights than his transferor had (See Section 7-502 (A.C.A. § 4-7-502)).

A document of title is negotiable only if it satisfies this section. "Deliverable on proper indorsement and surrender of this receipt" will not render a document negotiable. Bailees often include such provisions as a means of insuring return of nonnegotiable receipts for record purposes. Such language may be regarded as insistence by the bailee upon a particular kind of receipt in connection with delivery of the goods. Subsections (1)(a) and (2) (A.C.A. § 4-7-104(1)(a) and (2)) make it clear that a document is not negotiable

which provides for delivery to order or bearer only if written instructions to that effect are given by a named person.

*Cross Reference:*

Section 7-502 (A.C.A. § 4-7-502).

*Definitional Cross References:*

"Bearer". Section 1-201 (A.C.A. § 4-1-201).

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Overseas". Section 2-323 (A.C.A. § 4-2-323).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-105 (A.C.A. § 4-7-105)**

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

To avoid any impairment, for example, of any common-law right of indemnity a warehouseman may have corresponding

to Section 7-301(5) (A.C.A. § 4-7-301(5)), or of any contractual security interest a carrier might have corresponding to Section 7-209(2) (A.C.A. § 4-7-209(2)).

*Cross References:*

Parts 2 and 3 of Article (Chapter) 7.

**Comment to § 7-201 (A.C.A. § 4-7-201)**

*Prior Uniform Statutory Provision:*

Section 1, Uniform Warehouse Receipts Act.

*Changes:*

Provision added to cover storage under government bond or under licensing statute.

*Purposes:*

It is not intended by reenactment of subsection (1) (A.C.A. § 4-7-201(1)) to repeal any provisions of special licensing or other statutes regulating who may become a warehouseman. See Section 10-103 (A.C.A. § 4-10-103). Subsection (2) (A.C.A. § 4-7-201(2)) covers receipts issued by the owner for whiskey or other goods stored in bonded warehouses under

such statutes as 26 U.S.C. Chapter 26. Limitations on the transfer of the receipts and criminal sanctions for violation of such limitations are not impaired. Section 7-103 (A.C.A. § 4-7-103). Compare Section 7-401(d) (A.C.A. § 4-7-401(d)) on the liability of the issuer in such cases.

*Cross References:*

Sections 7-103 (A.C.A. § 4-7-103), 7-401 (A.C.A. § 4-7-401), 10-103 (A.C.A. § 4-10-103).

*Definitional Cross References:*

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-202 (A.C.A. § 4-7-202)**

*Prior Uniform Statutory Provision:*

Section 2, Uniform Warehouse Receipts Act.

*Changes:*

Exemption for field warehouse receipts added in subsection (2)(e) (A.C.A. § 4-7-202(2)(e)).

*Purposes:*

To make clear that the formal requirements of the Uniform Warehouse Receipts

Act are continued but not to displace particular legislation requiring other or different specifications of form. See Sections 7-103 (A.C.A. § 4-7-103) and 10-103 (A.C.A. § 4-10-103) [general repeal section; § 85-1-101 (A.C.A. § 4-1-101), note].\* This section does not require that a receipt be issued but states formal requirements for those which are issued.

*Cross References:*

Sections 7-103 (A.C.A. § 4-7-103) and



10-103 (A.C.A. § 4-10-103) [§ 85-1-101 (A.C.A. § 4-1-101), note].\*

*Definitional Cross References:*

"Bearer". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

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\*Bracketed language apparently added by compiler to the Arkansas Statutes Annotated.

**Comment to § 7-203 (A.C.A. § 4-7-203)**

*Prior Uniform Statutory Provision:*

Section 20, Uniform Warehouse Receipts Act.

*Changes:*

New section confined to problems of non-receipt and misdescription.

*Purposes of Changes and New Matter:*

This section is a simplified restatement of existing law as to the method by which a bailee may avoid responsibility for the accuracy of descriptions which are made by or in reliance upon information furnished by the depositor. The issuer is liable on documents issued by an agent, contrary to instructions of his principal, without receiving goods. No disclaimer of the latter liability is permitted.

*Cross References:*

Sections 7-301 (A.C.A. § 4-7-301) and 7-203 (A.C.A. § 4-7-203).

*Definitional Cross References:*

"Conspicuous". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Issuer". Section 7-102 (A.C.A. § 4-7-102).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Value". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-204 (A.C.A. § 4-7-204)**

*Prior Uniform Statutory Provision:*

Sections 3 and 21, Uniform Warehouse Receipts Act.

*Changes:*

Consolidated and rewritten; material on limitation of remedy is new.

*Purpose of Changes:*

The old uniform acts provided that receipts could not contain terms impairing the obligation of reasonable care. Whether this is violated by a stipulation that in case of loss the bailee's liability is limited to stated amounts has been much controverted. The section is intended to eliminate that controversy by setting forth the

conditions under which liability is so limited. However, as subsection (4)\* makes clear, the states as well as the federal government may supplement this section with more rigid standards of responsibility for some or all bailees.

*Cross References:*

Sections 7-103 (A.C.A. § 4-7-103) and 10-103 (A.C.A. § 4-10-103).

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Agreed". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Sign". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

\*Subsection (4) was not adopted in Arkansas.

### Comment to § 7-205 (A.C.A. § 4-7-205)\*

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

The typical case covered by this section is that of the warehouseman-dealer in grain, and the substantive question at issue is whether in case the warehouseman becomes insolvent the receipt holders shall be able to trace and recover grain shipped to farmers and other purchasers from the elevator. This was possible under the old acts, although courts were eager to find estoppels to prevent it. The practical difficulty of tracing fungible grain means that the preservation of this theoretical right adds little to the commercial acceptability of negotiable grain receipts, which really circulate on the credit of the warehouseman. Moreover, on default of the warehouseman, the receipt holders at least share in what grain remains, whereas retaking the grain from a good faith cash purchaser reduces him completely to the status of general creditor in a situation where there was very little he could do to guard against the loss. Compare 15 U.S.C. Section 714p [F.C.A., tit. 15, § 741p],\*\* enacted in 1955.

#### *Cross References:*

Sections 2-403 (A.C.A. § 4-2-403) and 9-307 (A.C.A. § 4-9-307).

#### *Definitional Cross References:*

"Buyer in ordinary course of business". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Duly negotiate". Section 7-501 (A.C.A. § 4-7-501).

"Fungible goods". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

\*This section was amended by Acts 1981, No. 401, § 3, making this section vary from the language of the Uniform Commercial Code section.

\*\*The bracketed language was apparently added by the compiler of the Arkansas Statutes of 1947 Annotated.

### Comment to § 7-206 (A.C.A. § 4-7-206)

#### *Prior Uniform Statutory Provision:*

Section 34, Uniform Warehouse Receipts Act.

#### *Changes:*

Rewritten and expanded to define the warehouseman's right to terminate the storage not only where the goods are perishable or hazardous as in Uniform Warehouse Receipts Act, Section 34, but also for any other reason including decline in value of the goods imperilling the warehouseman's security for charges.

#### *Purposes of Changes:*

1. Most warehousing is for an indefinite term, the bailor being entitled to delivery on reasonable demand. It is necessary to define the warehouseman's power to terminate the bailment, since it would be commercially intolerable to allow warehousemen to order removal of the goods on short notice. The thirty day period provided where the document does not carry its own period of termination corresponds to commercial practice of computing rates on a monthly basis. The



right to terminate under subsection (1) (A.C.A. § 4-7-206(1)) includes a right to require payment of "any charges", but does not depend on the existence of unpaid charges.

2. In permitting expeditious disposition of perishable and hazardous goods Uniform Warehouse Receipts Act, Section 34, made no distinction between cases where the warehouseman knowingly undertook to store such goods and cases where the goods were discovered to be of that character subsequent to storage. The former situation presents no such emergency as justifies the summary power of removal and sale. Subsections (2) (A.C.A. § 4-7-206(2)) and (3) (A.C.A. § 4-7-206(3)) distinguish between the two situations.

3. Protection of his lien is the only interest which the warehouseman has to justify summary sale of perishable goods which are not hazardous. This same interest must be recognized when the stored goods, although not perishable, decline in market value to a point which threatens the warehouseman's security.

4. The right to order removal of stored goods is subject to provisions of the public warehousing laws of some states forbidding warehousemen from discriminating among customers. Nor does the section relieve the warehouseman of any obligation under the state laws to secure the

approval of a public official before disposing of deteriorating goods. Such regulatory statutes and the regulations under them remain in force and operative. Sections 7-103 (A.C.A. § 4-7-103), 10-103 (A.C.A. § 4-10-103).

*Cross References:*

Sections 7-103 (A.C.A. § 4-7-103), 7-403 (A.C.A. § 4-7-403), 10-103 (A.C.A. § 4-10-103).

*Definitional Cross References:*

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

"Value". Section 1-201 (A.C.A. § 4-1-201).

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

**Comment to § 7-207 (A.C.A. § 4-7-207)**

*Prior Uniform Statutory Provision:*

Sections 22, 23 and 24, Uniform Warehouse Receipts Act.

*Changes:*

Consolidated and revised; holders of overissued receipts permitted to share in mass of fungible goods.

*Purposes of Changes:*

No change of substance is made other than the explicit statement that holders to whom overissued receipts have been duly negotiated shall share in a mass of fungible goods. Where individual ownership interests are merged into claims on a common fund, as is necessarily the case with fungible goods, there is no policy reason for discriminating between successive purchasers of similar claims.

*Definitional Cross References:*

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Duly negotiate". Section 7-501 (A.C.A. § 4-7-501).

"Fungible goods". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-208 (A.C.A. § 4-7-208)***Prior Uniform Statutory Provision:*

Section 13, Uniform Warehouse Receipts Act.

*Changes:*

Generally revised and simplified; explicit treatment of the situation where a blank in an executed document is filled without authority.

*Purposes of Changes:*

1. The execution of warehouse receipts in blank is a dangerous practice. As between the issuer and an innocent purchaser the risks should clearly fall on the former.

2. An unauthorized alteration whether made with or without fraudulent intent

does not relieve the issuer of his liability on the warehouse receipt as originally executed. The unauthorized alteration itself is of course ineffective against the warehouseman.

*Definitional Cross References:*

"Issuer". Section 7-102 (A.C.A. § 4-7-102).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-209 (A.C.A. § 4-7-209)\****Prior Uniform Statutory Provision:*

Sections 27 through 32, Uniform Warehouse Receipts Act.

*Changes:*

Rewritten.

*Purposes of Changes:*

1. Subsection (1) (A.C.A. § 4-7-209(1)) defines the warehouseman's statutory lien. A specific lien attaches automatically, without express notation on the receipt, to goods stored under a non-negotiable receipt. That lien is limited to the usual charges arising out of a storage transaction; by notation on the receipt it can be made a general lien extending to like charges in relation to other goods. The same rules apply where the receipt is negotiable, except that as against a holder by due negotiation the lien is limited to the amount or rate specified on the receipt, or, if none is specified, to a reasonable charge for storage of the specific goods after the date of the receipt.

2. Subsection (2) (A.C.A. § 4-7-209(2)) provides for a security interest based upon agreement. Such a security interest arises out of relations between the parties other than bailment for storage or transportation, as where the bailee assumes the role of financier or performs a manufacturing operation, extending credit in reliance upon the goods covered by the receipt. Such a security interest is not a statutory lien. Compare Sections 9-102(2) (A.C.A.

§ 4-9-102(2)) and 9-310 (A.C.A. § 4-9-310). It is governed in all respects by Article 9 (Chapter 9), except that subsection (2) (A.C.A. § 4-7-209(2)) requires that the receipt specify a maximum amount and limits the security interest to the amount specified.

3. Subsections (1) (A.C.A. § 4-7-209(1)) and (2) (A.C.A. § 4-7-209(2)) validate the lien and security interest "against the bailor." As against third parties, subsection (3)(a) (A.C.A. § 4-7-209(3)(a)) continues the rule under the prior uniform statutory provision that to validate the lien the owner must have entrusted the goods to the depositor, and that the circumstances must be such that a pledge by the depositor to a good faith purchaser for value would have been valid. Thus the owner's interest will not be subjected to a lien or security interest arising out of a deposit of his goods by a thief. The warehouseman may be protected because of the actual, implied or apparent authority of the depositor, because of a Factor's Act, or because of other circumstances which would protect a bona fide pledgee, unless those circumstances are denied effect under Section 7-503 (A.C.A. § 4-7-503). Where the third party is the holder of a security interest, the rights of the warehouseman depend on the priority given to a hypothetical bona fide pledgee by Article 9 (Chapter 9), particularly Section 9-312 (A.C.A. § 4-9-312). Thus the special prior-



ity granted to statutory liens by Section 9-310 (A.C.A. § 4-9-310) does not apply to liens under subsection (1) of this section (A.C.A. § 4-7-209(1)), since subsection (3) (A.C.A. § 4-7-209(3)) "expressly provides otherwise" within the meaning of Section 9-310 (A.C.A. § 4-9-310). As to household goods, however, subsection (3)(b) (A.C.A. § 4-7-209(3)(b)) makes the warehouseman's lien "for charges and expenses in relation to the goods" effective against all persons if the depositor was the legal possessor. The purpose of the exception is to permit the warehouseman to accept household goods for storage in sole reliance on the value of the goods themselves, especially in situations of family emergency. [This paragraph was amended in 1966].

4. It is unnecessary to state here, as in Uniform Warehouse Receipts Act 31, that a bailee with a valid lien need not deliver until the lien is satisfied. Section 7-403 (A.C.A. § 4-7-403) provides that a person demanding delivery under a document must be prepared to satisfy the bailee's lien.

5. Where goods have been stored under a non-negotiable warehouse receipt and are sold by the person to whom the receipt has been issued, frequently the goods are not withdrawn by the new owner. The obligations of the seller of the goods in this situation are set forth in Section 2-503(4) (A.C.A. § 4-2-503(4)) on tender of delivery and include procurement of an acknowledgment by the bailee of the buyer's right to possession of the goods. If a new receipt is requested, such an acknowledgment can be withheld until storage charges have been paid or provided for. The statutory lien for charges on the goods sold, granted by the first sentence of subsection (1) (A.C.A. § 4-7-209(1)), continues valid unless the bailee gives it up. But once a new receipt is issued to the buyer, the buyer becomes "the person on whose account the goods are held" under the second sentence of subsection (1) (A.C.A. § 4-7-209(1)); unless he undertakes liability for

charges in relation to other goods stored by the seller, there is no general lien against the buyer for such charges. Of course, the bailee may preserve the general lien in such a case either by an arrangement by which the buyer "is liable for" such charges, or by reserving a security interest under subsection (2) (A.C.A. § 4-7-209(2)).

#### *Cross References:*

Point 2: Sections 9-102(2) (A.C.A. § 4-9-102(2)) and 9-310 (A.C.A. § 4-9-310).

Point 3: Sections 7-503 (A.C.A. § 4-7-503), 9-310 (A.C.A. § 4-9-310) and 9-312 (A.C.A. § 4-9-312).

Point 4: Section 7-403 (A.C.A. § 4-7-403).

Point 5: Section 2-503 (A.C.A. § 4-2-503).

#### *Definitional Cross References:*

"Deliver". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 20, to incorporate the 1966 changes to this Uniform Commercial Code section.

**Comment to § 7-210 (A.C.A. § 4-7-210)***Prior Uniform Statutory Provision:*

Section 33, Uniform Warehouse Receipts Act.

*Changes:*

Rewritten; simplified foreclosure proceeding provided for all liens other than warehousemen's lien in non-commercial storage.

*Purposes of Changes:*

1. Subsection (1) (A.C.A. § 4-7-210(1)) makes "commercial reasonableness" the standard for foreclosure proceedings in all cases except non-commercial storage with a warehouseman. The latter category embraces principally storage of household goods by private owners; and for such cases the detailed provisions as to notification, publication and public sale, found in Section 33 of the Uniform Warehouse Receipts Act, are retained in subsection (2) (A.C.A. § 4-7-210(2)). The swifter, more flexible procedure of subsection (1) (A.C.A. § 4-7-210(1)) is appropriate to commercial storage. Compare seller's power of resale on breach by buyer under the provisions of the Article (Chapter) on Sales (Section 2-706 (A.C.A. § 4-2-706)).

2. The provisions of subsections (4) (A.C.A. § 4-7-210(4)) and (5) (A.C.A. § 4-7-210(5)) permitting the bailee to bid at public sales and confirming the title of purchasers at foreclosure sales are de-

signed to secure more bidding and better prices.

*Cross Reference:*

Section 7-403 (A.C.A. § 4-7-403).

*Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Conspicuous". Section 1-201 (A.C.A. § 4-1-201).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

**Comment to § 7-301 (A.C.A. § 4-7-301)\****Prior Uniform Statutory Provision:*

Section 23, Uniform Bills of Lading Act.

*Changes:*

Rewritten in part.

*Purposes of Changes:*

1. The provision as to misdating in subsection (1) (A.C.A. § 4-7-301(1)) conforms to the policy of the amendment to the Federal Bills of Lading Act by 44 Stat. 1450 (1927), as amended 49 U.S.C. Section 102 [F.C.A., tit. 49, § 102], after the holding in *Browne v. Union Pac. R. Co.*, 113 Kan. 726, 216 P. 299 (1923), affirmed on other grounds, 267 U.S. 255, 45 S.Ct. 315, 69 L.Ed. 601 (1925). Subsections (2) (A.C.A. § 4-7-301(2)) and (3) (A.C.A. § 4-7-301(3)) conform to the policy of the Federal Bills of Lading Act, 49 U.S.C. Sections

100, 101 [F.C.A., tit. 49, §§ 100, 101]\*\* and the laws of several states. See, e.g., N.Y.Pers. Prop. Law Section 209; Report of N.Y. Law Revision Commission, N.Y.Leg.Doc. (1941) No. 65(F).

2. The language of the old Uniform Act suggested that a carrier is ordinarily liable for damage caused by improper loading, but may relieve himself of liability by disclosing on the bill that shipper actually loaded. A more accurate statement of the law is that the carrier is not liable for losses caused by act or default of the shipper, which would include improper loading. There is some question whether under present law a carrier is liable even to a good faith purchaser of a negotiable bill for such losses, if the shipper's faulty loading in fact caused the loss. It is this



doubtful liability which subsection (4) (A.C.A. § 4-7-301(4)) permits the carrier to bar by disclosure of shipper's loading. There is no implication the decisions such as *Modern Tool Corp. v. Pennsylvania R. Co.*, 100 F. Supp. 595 (D.N.J.1951), are disapproved.

3. This section is a simplified restatement of existing law as to the method by which a bailee may avoid responsibility for the accuracy of descriptions which are made by or in reliance upon information furnished by the depositor or shipper. The issuer is liable on documents issued by an agent, contrary to instructions of his principal, without receiving goods. No disclaimer of this liability is permitted since it is not a matter either of the care of the goods or their description.

4. The shipper's erroneous report to the carrier concerning the goods may cause damage to the carrier. Subsection (5) (A.C.A. § 4-7-301(5)) therefore provides appropriate indemnity.

#### *Cross References:*

Sections 7-203 (A.C.A. § 4-7-203) and 7-309 (A.C.A. § 4-7-309).

#### *Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Consignee". Section 7-102 (A.C.A. § 4-7-102).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Duly negotiate". Section 7-501 (A.C.A. § 4-7-501).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 7-102 (A.C.A. § 4-7-102).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 21, to conform it to the Uniform Commercial Code section to correct typographical errors made in the original enactment by the Arkansas General Assembly.

\*\*Bracketed language apparently inserted by the compiler to Arkansas Statutes of 1947 Annotated.

### **Comment to § 7-302 (A.C.A. § 4-7-302)**

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

1. The purpose of this section is to subject the initial carrier under a through bill to suit for breach of the contract of carriage by any connecting carrier and to make it clear that any such connecting carrier holds the goods on terms which are defined by the document of title even though such connecting carrier did not issue the document. Since the connecting carrier does hold on the terms of the document, it must honor a proper demand for delivery or a diversion order just as the original bailee would have to do. Similarly it has the benefits of the excuses for non-delivery and limitations of liability provided for the original bailee. Unlike the original bailee-issuer, the connecting carrier's responsibility is limited to the pe-

riod while the goods are in its possession. The section is patterned generally after the Interstate Commerce Act, but does not impose any obligation to issue through bills.

2. The reference to documents other than through bills looks to the possibility that multi-purpose documents may come into use, e.g., combination warehouse receipts and bills of lading.

3. Where the obligations or standards applicable to different parties bound by a document of title are different, the initial carrier's responsibility for portions of the journey not on its own lines will be determined by the standards appropriate to the connecting carrier. Thus a land carrier issuing a through bill of lading involving water carriage at a later stage will have the benefit of the water carrier's immunity from liability for negligence of its

servants in navigating the vessel, where the law provides such an immunity for water carriers and the loss occurred while the goods were in the water carrier's possession.

4. Under subsection (1) (A.C.A. § 4-7-302(1)) the issuer of a through bill of lading may become liable for the fault of another person. Subsection (3) (A.C.A. § 4-7-302(3)) gives it appropriate rights of recourse.

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Issuer". Section 7-102 (A.C.A. § 4-7-102).

"Overseas". Section 2-323 (A.C.A. § 4-2-323).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-303 (A.C.A. § 4-7-303)**

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. The old Acts contained no reference to diversion, a very common commercial practice which defeats delivery to the consignee originally named in a bill of lading. The carrier was protected under the heading of "justified delivery" if the substituted consignee who received delivery was "a person lawfully entitled to possession of the goods." Cf. subsection (1)(d) (A.C.A. § 4-7-303(1)(d)). This in turn depended on whether the person ordering the diversion was the owner of the goods or empowered to dispose of them, which again might depend upon whether under sales law title had passed from the consignor-seller to the consignee-buyer. The carrier is plainly not in a position to decide such questions when directed by the person with whom it has contracted for transportation to change the destination of the goods in transit. Carriers may as a business matter be willing to accept instructions from consignees in which case, as under the old uniform acts, the carrier will be liable for misdelivery if the consignee was not the owner or otherwise empowered to dispose of the goods. The section imposes no duty on carriers to undertake diversion; it is of course subject to the provisions of filed tariffs. Section 7-103 (A.C.A. § 4-7-103).

2. It should be noted that the section provides only an immunity for carriers against liability for "misdelivery." It does

not, for example, defeat the title to the goods which the consignee-buyer may have acquired from the consignor-seller upon delivery of the goods to the carrier under a non-negotiable bill of lading. Thus if the carrier, upon instructions from the consignor, returns the goods to him, the consignee may recover the goods from the consignor or his insolvent estate. However, under certain circumstances, the consignee's title may be defeated by diversion of the goods in transit to a different consignee.

*Cross References:*

Point 2: Sections 7-403 (A.C.A. § 4-7-403) and 7-504(3) (A.C.A. § 4-7-504(3)).

*Definitional Cross References:*

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Consignee". Section 7-102 (A.C.A. § 4-7-102).

"Consignor". Section 7-102 (A.C.A. § 4-7-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).



"Term". Section 1-201 (A.C.A. § 4-1-201).

### Comment to § 7-304 (A.C.A. § 4-7-304)

*Prior Uniform Statutory Provision:*

Section 6, Uniform Bills of Lading Act.

*Changes:*

This section adds to existing legislation, which merely prohibits bills in a set in ordinary domestic trade, a statement of the legal effect of a lawfully issued set.

*Purposes of Changes:*

The statement of the legal effect of a lawfully issued set is in accord with existing commercial law relating to maritime and other overseas bills. This law has been codified in the Hague and Warsaw Conventions and in the Carriage of Goods by Sea Act, the provisions of which would ordinarily govern in situations where bills in a set are recognized by this Article (Chapter).

*Cross Reference:*

Section 10-103 (A.C.A. § 4-10-103).

*Definitional Cross References:*

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Bill of lading". Section 7-102 (A.C.A. § 4-7-102).\*

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Duly negotiate". Section 7-501 (A.C.A. § 4-7-501).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 7-102 (A.C.A. § 4-7-102).

"Overseas". Section 2-323 (A.C.A. § 4-2-323).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

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\*"Bill of lading" is actually defined in A.C.A. § 4-1-201 rather than in A.C.A. § 4-7-102 as stated in the Uniform Commercial Code Comments.

### Comment to § 7-305 (A.C.A. § 4-7-305)

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

This proposal is designed to facilitate the use of order bills in connection with fast shipments. Use of order bills on high speed shipments is impeded by the fact that the goods may arrive at destination before the documents, so that no one is ready to take delivery from the carrier. This is especially inconvenient for carriers by truck and air, who do not have terminal facilities where shipments can be held to await consignee's appearance. Order bills would be useful to take advantage of bank collection. This may be preferable to C.O.D. shipment in which the carrier, e.g., a truck driver, is the collecting and remitting agent. Financing of shipments under this plan would be handled as follows: seller at San Francisco delivers goods to

an airline with instructions to issue a bill in New York to a named bank. Seller receives a receipt embodying this undertaking to issue a destination bill. Airline wires its New York freight agent to issue the bill as instructed by the seller. Seller wires the New York bank a draft on buyer. New York bank indorses the bill to buyer when he honors the draft. Normally seller would act through his own bank in San Francisco, which would extend him credit in reliance on the airline's contract to deliver a bill to the order of its New York correspondent. This section is entirely permissive; it imposes no duty to issue such bills. Whether a connecting carrier will act as issuing agent is left to agreement between carriers.

*Definitional Cross References:*

"Consignor". Section 7-102 (A.C.A. § 4-7-102).

"Issuer". Section 7-102 (A.C.A. § 4-7-102).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

### Comment to § 7-306 (A.C.A. § 4-7-306)

#### *Prior Uniform Statutory Provision:*

Section 16, Uniform Bills of Lading Act.

#### *Changes:*

Generally revised and simplified; explicit treatment of the situation where a blank in an executed document is filled without authority.

#### *Purposes of Changes:*

An unauthorized alteration whether made with or without fraudulent intent does not relieve the issuer of his liability on the document as originally executed. Uniform Warehouse Receipts Act 13 excused the issuer from any liability to a fraudulent alterer, other than the liability to deliver the goods according to the terms of the original document. It is difficult to conceive what liability the draftsman intended to excuse. Uniform Bills of Lading Act 16 contains no such excuse provision,

and is followed in this respect in the present section. Uniform Bills of Lading Act 16 characterizes an unauthorized alteration as "void" but apparently nothing more was intended than that the alteration did not change the obligation of the issuer. This is sufficiently covered by the terms of this section. Moreover cases are conceivable in which an alteration would not be "void"; for example, an alteration made by common consent of a transferor and transferee of a document might evidence an enforceable contract between them. The same rule is made applicable to the filling in of blanks, a matter on which the prior Acts were silent.

#### *Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 7-102 (A.C.A. § 4-7-102).

### Comment to § 7-307 (A.C.A. § 4-7-307)

#### *Prior Uniform Statutory Provision:*

Sections 27 through 32, Uniform Warehouse Receipts Act.

#### *Changes:*

Rewritten; lien extended to carrier. Lien of common carrier validated unless carrier had notice that consignor lacked authority to subject the goods to charges and expenses. Where the carrier is not required by law to receive the goods for transportation, lien validated against anyone who permitted the bailor to have possession even if he had no real or apparent authority.

#### *Purposes of Changes:*

The section is intended to give carriers a specific statutory lien for charges and expenses similar to that given to warehousemen by the first sentence of Section 7-209 (A.C.A. § 4-7-209). But since carriers do not commonly claim a lien for charges in relation to other goods or lend money on the security of goods in their hands, provisions for a general lien or a security interest similar to those in Section 7-209(1) and (2) (A.C.A. § 4-7-209(1) and (2)) are omitted. See Comment to Section

7-105 (A.C.A. § 4-7-105). Since the lien given by this section is specific, and the storage or transportation often preserves or increases the value of the goods, subsection (2) (A.C.A. § 4-7-209(2)) validates the lien against anyone who permitted the bailor to have possession of the goods. Where the carrier is required to receive the goods for transportation, the owner's interest may be subjected to charges and expenses arising out of deposit of his goods by a thief. Cf. Section 9-310 (A.C.A. § 4-9-310). The crucial mental element is the carrier's knowledge or reason to know of the bailor's lack of authority.

#### *Cross References:*

Sections 7-209 (A.C.A. § 4-7-209), 9-102(2) (A.C.A. § 4-9-102(2)), and 9-310 (A.C.A. § 4-9-310).

#### *Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Consignor". Section 7-102 (A.C.A. § 4-7-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).



"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

### Comment to § 7-308 (A.C.A. § 4-7-308)\*

#### *Prior Uniform Statutory Provision:*

Section 33, Uniform Warehouse Receipts Act.

#### *Changes:*

Rewritten; provisions extended to carriers' liens; simplified foreclosure proceeding provided.

#### *Purposes of Changes:*

This section is intended to give the carrier an enforcement procedure of his lien coextensive with that given the warehousemen in cases other than those covering noncommercial storage by him. See Comment to Section 7-210 (A.C.A. § 4-7-210).

#### *Cross Reference:*

Section 7-210 (A.C.A. § 4-7-210).

#### *Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Notifies". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 22, to make it conform to the Uniform Commercial Code by adding subsection (8), which was omitted from the original enactment by the Arkansas General Assembly.

### Comment to § 7-309 (A.C.A. § 4-7-309)

#### *Prior Uniform Statutory Provision:*

Section 3, Uniform Bills of Lading Act.

#### *Changes:*

Consolidated and rewritten.

#### *Purposes of Changes:*

The old uniform act provided that bills of lading could not contain terms impairing the obligation of reasonable care. Whether this is violated by a stipulation that in case of loss the bailee's liability is limited to stated amounts has been much controverted. For interstate rail transportation the matter is settled by the Carmack Amendment to the Interstate Commerce Act (see 49 U.S.C. § 20(11) [F.C.A., tit. 49, § 20(11)]).<sup>\*</sup> The present section is a generalized version of the Interstate Commerce Act provisions. The obligation of due care is radically qualified, in the case of maritime bills and

international airbills, by federal legislation and treaty. All this special legislation would remain in effect even if Congress enacts this Code, including the present Article (Chapter). See Section 7-103 (A.C.A. § 4-7-103).

Subsection (1) (A.C.A. § 4-7-309(1)) does not impair any rule of law imposing the liability of an insurer on a common carrier in intrastate commerce. Subsection (2) (A.C.A. § 4-7-309(2)), however, applies to such liability as well as to liability based on negligence. The entire section is subject under Section 7-103 (A.C.A. § 4-7-103) to applicable provisions in filed tariffs, such as the common disclaimer of responsibility for undeclared articles of extraordinary value, hidden from view. Tariffs which lawfully provide a maximum unit value beyond which goods are not taken fall within the same

principle, and are expressly covered by the words "value as lawfully provided in the tariff."

*Cross Reference:*

Section 7-103 (A.C.A. § 4-7-103).

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Consignor". Section 7-102 (A.C.A. § 4-7-102).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

\*Bracketed language was apparently inserted by the compiler of the Arkansas Statutes of 1947 Annotated.

**Comment to § 7-401 (A.C.A. § 4-7-401)**

*Prior Uniform Statutory Provision:*

Section 20, Uniform Warehouse Receipts Act; Section 23, Uniform Bills of Lading Act.

*Changes:*

Most of the material is new; the uniform act sections cited deal only with non-receipt and misdescription.

*Purposes of Changes and New Matter:*

The bailee's liability on his document despite non-receipt or misdescription of the goods is affirmed in Sections 7-203 (A.C.A. § 4-7-203) and 7-301 (A.C.A. § 4-7-301). The purpose of this section is to make it clear that regardless of irregularities a document which falls within the definition of document of title imposes on the issuer the obligations stated in this Article (Chapter). For example, a bailee will not be permitted to avoid his obligation to deliver the goods (Section 7-403 (A.C.A. § 4-7-403)) or his obligation of due care with respect to them (Sections 7-204 (A.C.A. § 4-7-204) and 7-309 (A.C.A. § 4-7-309)) by taking the position that no valid "document" was issued because he failed to file a statutory bond or did not pay stamp taxes or did not disclose the place of storage in the document. Sanctions against violations of statutory or administrative duties with respect to doc-

uments should be limited to revocation of license or other measures prescribed by the regulation imposing the duty. As to the continuing vitality of regulations, in addition to those found in this Article (Chapter), of documents of title, see Sections 7-103 (A.C.A. § 4-7-103) and 10-103 (A.C.A. § 4-10-103).

*Cross References:*

Sections 7-103 (A.C.A. § 4-7-103), 7-203 (A.C.A. § 4-7-203), 7-204 (A.C.A. § 4-7-204), 7-301 (A.C.A. § 4-7-301), 7-309 (A.C.A. § 4-7-309) and 10-103 (A.C.A. § 4-10-103).

*Definitional Cross References:*

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Issuer". Section 7-102 (A.C.A. § 4-7-102).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

**Comment to § 7-402 (A.C.A. § 4-7-402)**

*Prior Uniform Statutory Provision:*

Section 6, Uniform Warehouse Receipts Act; Section 7, Uniform Bills of Lading Act.

*Changes:*

Consolidated and rewritten.

*Purposes of Changes:*

1. This section treats a duplicate which is not properly identified as such like any other overissue of documents: a purchaser of such a document acquires no title but only a cause of action for damages against



the person who made his deception possible, except in the cases noted in the section. But parts of a bill lawfully issued in a set of parts are not "overissue" (Section 7-304 (A.C.A. § 4-7-304)). Of course, if the issuer has clearly indicated that a document is a duplicate so that no one can be deceived by it, and in fact the duplicate is a correct copy of the original, the warehouseman is not liable for preparing and delivering such a duplicate copy.

2. The section applies to nonnegotiable documents to the extent of providing an action for damages for one who acquires an unmarked duplicate from a transferor who knew the facts and would therefore himself have had no cause of action against the issuer of the duplicate. Ordinarily the transferee of a nonnegotiable document acquires only the rights of his transferor.

3. Overissue is defined so as to exclude the common situation where two valid documents of different issuers are outstanding for the same goods at the same time. Thus freight forwarders commonly issue bills of lading to their customers for small shipments to be combined into carload shipments for which the railroad will issue a bill of lading to the forwarder. So also a warehouse receipt may be outstanding against goods, and the holder of the receipt may issue delivery orders against the same goods. In these cases dealings

with the subsequently issued documents may be effective to transfer title; e.g., negotiation of a delivery order will effectively transfer title in the ordinary case where no dishonesty has occurred and the goods are available to satisfy the orders. Section 7-503 (A.C.A. § 4-7-503) provides for cases of conflict between documents of different issuers.

*Cross References:*

Point 1: Sections 7-207 (A.C.A. § 4-7-207), 7-304 (A.C.A. § 4-7-304), and 7-601 (A.C.A. § 4-7-601).

Point 3: Section 7-503 (A.C.A. § 4-7-503).

*Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Conspicuous". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Fungible goods". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Issuer". Section 7-102 (A.C.A. § 4-7-102).

"Right". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-403 (A.C.A. § 4-7-403)\***

*Prior Uniform Statutory Provision:*

Sections 8 through 12, 16 and 19, Uniform Warehouse Receipts Act; Sections 11 through 15, 19 and 22, Uniform Bills of Lading Act.

*Changes:*

Consolidated and rewritten.

*Purposes of Changes:*

1. The general and primary purpose of this revision is to simplify the statement of the bailee's obligation on the document. The interrelations of the separate sections of the old uniform acts dealing with "obligation to deliver," "justification in delivering," and "liability for misdelivery" are obscure. The present section is constructed on the basis of stating what previous deliveries or other circumstances operate to excuse the bailee's normal obli-

gation on the document. Accordingly, "justified" deliveries under the old uniform acts now find their place as "excuse" under subsection (1) (A.C.A. § 4-7-403(1)). Unjustified deliveries, i.e., "misdeliveries" under the old acts, are simply omitted from the list of excuses, thus permitting the normal obligation on the document to be asserted.

2. The principal case covered by subsection (1)(a) (A.C.A. § 4-7-403(1)(a)) is delivery to a person whose title is paramount to the rights represented by the document. For example, if a thief deposits stolen goods in a warehouse and takes a negotiable receipt, the warehouseman is not liable on the receipt if he has surrendered the goods to the true owner, even though the receipt is held by a good faith purchaser. See Section 7-503(1) (A.C.A. § 4-7-503(1)). However, if the owner entrusted

the goods to a person with power of disposition, and that person deposited the goods and took a negotiable document, the owner's receipt would not be rightful as against a holder to whom the negotiable document was duly negotiated, and delivery to the owner would not give the bailee a defense against such a holder. See Sections 7-502(1)(b) (A.C.A. § 4-7-502(1)(b)), 7-503 (1)(a) (A.C.A. § 4-7-503(1)(a)).

3. Subsection (1)(b) (A.C.A. § 4-7-403(1)(b)) amounts to a cross reference to all the tort law that determines the varying responsibilities and standards of care applicable to commercial bailees. A restatement of this tort law would be beyond the scope of this Act. Much of the applicable law as to responsibility of bailees for the preservation of the goods and limitation of liability in case of loss has been codified for particular classes of bailees in interstate and foreign commerce by federal legislation and treaty and for intrastate carriers and other bailees by the regulatory state laws preserved by Section 7-103 (A.C.A. § 4-7-103). In the absence of governing legislation the common law will prevail subject to the minimum standard of reasonable care prescribed by Sections 7-204 (A.C.A. § 4-7-204) and 7-309 (A.C.A. § 4-7-309) of this Article (Chapter). The optional language in subsection (1)(b) (A.C.A. § 4-7-403(1)(b)) states the rule laid down for interstate carriers in many federal cases. State decisions are in conflict as to both carriers and warehousemen. Particular states may prefer to adopt the federal rule.

4. Subsection (2) (A.C.A. § 4-7-403(2)) eliminates the implication of the old uniform acts that a request for delivery must be accompanied by a formal tender of the amount of the charges due. Rather, the bailee must request payment of the amount of his lien when asked to deliver, and only in case this request is refused is he justified in declining to deliver because of nonpayment of charges. Where delivery without payment is forbidden by law, the request is treated as implicit. Such a prohibition reflects a policy of uniformity to prevent discrimination by failure to request payment in particular cases.

5. Subsection (3) (A.C.A. § 4-7-403(3)) states the obvious duty of a bailee to take

up a negotiable document or note partial deliveries conspicuously thereon, and the result of failure in that duty. It is subject to only one exception, that stated in subsection 1(a) of this section (A.C.A. § 4-7-403(1)(a)) and in Section 7-503(1) (A.C.A. § 4-7-503(1)). It is limited to cases of delivery to a claimant; it has no application, for example, where goods held under a negotiable document are lawfully sold to enforce the bailee's lien.

#### *Cross References:*

Point 2: Sections 7-502 (A.C.A. § 4-7-502) and 7-503 (A.C.A. § 4-7-503).

Point 3: Sections 7-103 (A.C.A. § 4-7-103), 7-204 (A.C.A. § 4-7-204), 7-309 (A.C.A. § 4-7-309) and 10-103 (A.C.A. § 4-10-103) [note to § 85-1-101 (A.C.A. § 4-1-101)].

Point 5: Section 7-503(1) (A.C.A. § 4-7-503(1)).

#### *Definitional Cross References:*

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Conspicuous". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Duly negotiate". Section 7-501 (A.C.A. § 4-7-501).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Terms". Section 1-201 (A.C.A. § 4-1-201).

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

"Written". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 23, to adopt the bracketed optional language at the end of subsection (1)(b).



**Comment to § 7-404 (A.C.A. § 4-7-404)***Prior Uniform Statutory Provision:*

Section 10, Uniform Warehouse Receipts Act; Section 13, Uniform Bills of Lading Act.

*Changes:*

Consolidated and rewritten.

*Purposes of Changes:*

The generalized test of good faith and observance of reasonable commercial standards is substituted for the attempts to particularize what constitutes good faith in the cited sections of the old uniform acts. The section states explicitly what is perhaps an implication from the old acts that the common law rule of "innocent conversion" by unauthorized "intermeddling" with another's property is inapplicable to the operations of commercial carriers and warehousemen, who in good faith and with reasonable observance of commercial standards perform obligations which they have assumed and

which generally they are under a legal compulsion to assume. The section applies to delivery to a fraudulent holder of a valid document as well as to delivery to the holder of an invalid document.

*Definitional Cross References:*

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Receipt of goods". Section 2-103 (A.C.A. § 4-2-103).

"Term". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-501 (A.C.A. § 4-7-501)\****Prior Uniform Statutory Provision:*

Sections 28, 29, 31, 32 and 38, Uniform Sales Act; Sections 37, 38, 39, 40 and 47, Uniform Warehouse Receipts Act; Sections 9, 28, 29, 30, 31 and 38, Uniform Bills of Lading Act.

*Changes:*

Consolidated and rewritten.

*Purposes of Changes:*

1. In general this section is intended to clarify the language of the old acts and to restate the effect of the better decisions thereunder. An important new concept is added, however, in the requirement of "regular course of business or financing" to effect the "due negotiation" which will transfer greater rights than those held by the person negotiating. The foundation of the mercantile doctrine of good faith purchase for value has always been, as shown by the case situations, the furtherance and protection of the regular course of trade. The reason for allowing a person, in bad faith or in error, to convey away rights which are not his own has from the beginning been to make possible the speedy handling of that great run of commercial transactions which are patently usual and normal.

There are two aspects to the usual and normal course of mercantile dealings, namely, the person making the transfer and the nature of the transaction itself. The first question which arises is: Is the transferor a person with whom it is reasonable to deal as having full powers? In regard to documents of title the only holder whose possession appears, commercially, to be in order is almost invariably a person in the trade. No commercial purpose is served by allowing a tramp or professor to "duly negotiate" an order bill of lading for hides or cotton not his own, and since such a transfer is obviously not in the regular course of business, it is excluded from the scope of the protection of subsection (4) (A.C.A. § 4-7-501(4)).

The second question posed by the "regular course" qualification is: Is the transaction one which is normally proper to pass full rights without inquiry, even though the transferor himself may not have such rights to pass, and even though he may be acting in breach of duty? In raising this question the "regular course" criterion has the further advantage of limiting the effective wrongful disposition to transactions whose protection will re-

ally further trade. Obviously, the snapping up of goods for quick resale at a price suspiciously below the market deserves no protection as a matter of policy: it is also clearly outside the range of regular course.

Any notice from the face of the document sufficient to put a merchant on inquiry as to the "regular course" quality of the transaction will frustrate a "due negotiation". Thus irregularity of the document on its face or unexplained staleness of a bill of lading may appropriately be recognized as negating a negotiation in "regular" course.

A pre-existing claim constitutes value, and "due negotiation" does not require "new value." A usual and ordinary transaction in which documents are received as security for credit previously extended may be in "regular" course, even though there is a demand for additional collateral because the creditor "deems himself insecure." But the matter has moved out of the regular course of financing if the debtor is thought to be insolvent, the credit previously extended is in effect canceled, and the creditor snatches a plank in the shipwreck under the guise of a demand for additional collateral. Where a money debt is "paid" in commodity paper, any question of "regular" course disappears, as the case is explicitly excepted from "due negotiation".

2. Negotiation under this section may be made by any holder no matter how he acquired possession of the document. The present section follows in this respect the Uniform Bills of Lading Act and amendments of the original Uniform Sales Act and Uniform Warehouse Receipts Act proposed by the Commissioners on Uniform State Laws in 1922.

3. Subsection (2)(b) (A.C.A. § 4-7-501(2)(b)) makes explicit a matter upon which the intent of the old acts was clear but the language somewhat obscure: a negotiation results from a delivery to a banker or buyer to whose order the document has been taken by the person making the bailment. There is no presumption of irregularity in such a negotiation; it may very well be in "regular course."

4. This Article (Chapter) does not contain any provision creating a presumption

of due negotiation to, and full rights in, a holder of a document of title akin to that created by Sections 16, 24 and 59 of the Negotiable Instruments Law. But the reason of the provisions of this Act (Section 1-202 (A.C.A. § 4-1-202)) on the *prima facie* authenticity and accuracy of third party documents, joins with the reason of the present section to work such a presumption in favor of any person who has power to make a due negotiation. It would not make sense for this Act to authorize a purchaser to indulge the presumption of regularity if the courts were not called upon to do so.

#### *Cross References:*

Point 1: Sections 7-502 (A.C.A. § 4-7-502) and 7-503 (A.C.A. § 4-7-503).

Point 2: Section 7-502 (A.C.A. § 4-7-502).

#### *Definitional Cross References:*

"Bearer". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 24, to make it conform to the Uniform Commercial Code section by correcting a grammatical error in subsection (3) in the original enactment by the Arkansas General Assembly.



### Comment to § 7-502 (A.C.A. § 4-7-502)\*

#### *Prior Uniform Statutory Provision:*

Sections 20(4), 25, 33, 38 and 62, Uniform Sales Act; Sections 41, 47, 48 and 49, Uniform Warehouse Receipts Act; Sections 32, 38, 39, 40 and 42, Uniform Bills of Lading Act.

#### *Changes:*

Rewritten.

#### *Purposes of Changes:*

1. The several necessary qualifications of the broad principle that the holder of a document acquired in a due negotiation is the owner of the document and the goods have been brought together in the next section.

2. Subsection (1)(c) (A.C.A. § 4-7-502(1)(c)) covers the case of "feeding" of a duly negotiated document by subsequent delivery to the bailee of such goods as the document falsely purported to cover; the bailee in such case is estopped as against the holder of the document.

3. The explicit statement in subsection (1)(d) (A.C.A. § 4-7-502(1)(d)) of the bailee's direct obligation to the holder precludes the defense, sometimes successfully asserted under the old acts, that the document in question was "spent" after the carrier had delivered the goods to a previous holder. But the holder is subject to such defenses as non-negligent destruction even though not apparent on the face of the document, and the bailee's obligation is of course subject to lawful provisions in filed classifications and tariffs. See Sections 7-103 (A.C.A. § 4-7-103), 7-403 (A.C.A. § 4-7-403). The sentence on delivery orders applies only to delivery orders in negotiable form which have been duly negotiated. On delivery orders, see also Section 7-503(2) (A.C.A. § 4-7-503(2)) and Comment.

4. Subsection (2) (A.C.A. § 4-7-502(2)) condenses and continues the law of a number of sections of the prior acts which gave full effect to the issuance or due negotiation of a negotiable document. The subsection adds nothing to the effect of the rules stated in subsection (1) (A.C.A. § 4-7-502(1)), but it has been included since such explicit references were relied upon under the prior acts to preserve the rights

of a purchaser by due negotiation unimpaired. The listing is not exhaustive. Only those matters have been repeated in this subsection which were explicitly reserved in the prior acts except in the case of stoppage of transit. Here, the language has been broadened to include "any stoppage" lest an inference be drawn that a stoppage of the goods before or after transit might cut off or otherwise impair the purchaser's rights.

#### *Cross References:*

Sections 7-103 (A.C.A. § 4-7-103), 7-205 (A.C.A. § 4-7-205), 7-403 (A.C.A. § 4-7-403) and 7-503 (A.C.A. § 4-7-503).

#### *Definitional Cross References:*

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Delivery order". Section 7-102 (A.C.A. § 4-7-102).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Duly negotiate". Section 7-501 (A.C.A. § 4-7-501).

"Fungible". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 7-102 (A.C.A. § 4-7-102).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 25, but there doesn't appear to be any difference between that section as originally enacted, Acts 1961, No. 185, § 7-502, and the Uniform Commercial Code section.

**Comment to § 7-503 (A.C.A. § 4-7-503)***Prior Uniform Statutory Provision:*

Section 33, Uniform Sales Act; Section 41, Uniform Warehouse Receipts Act; Section 32, Uniform Bills of Lading Act.

*Changes:*

Subsection (1) (A.C.A. § 4-7-503(1)) narrows, as compared to the cited sections, the occasions for defeating the document holder's title.

*Purposes of Changes:*

1. In general it may be said that the title of a purchaser by due negotiation prevails over almost any interest in the goods which existed prior to the procurement of the document of title if the possession of the goods by the person obtaining the document derived from any action by the prior claimant which introduced the goods into the stream of commerce or carried them along that stream. A thief of the goods cannot indeed by shipping or storing them to his own order acquire power to transfer them to a good faith purchaser. Nor can a tenant or mortgagor defeat any rights of a landlord or mortgagee which have been perfected under the local law merely by wrongfully shipping or storing a portion of the crop or other goods. However, "acquiescence" by the landlord or tenant does not require active consent under subsection (1)(b) (A.C.A. § 4-7-503(1)(b)) and knowledge of the likelihood of storage or shipment with no objection or effort to control it is sufficient to defeat his rights as against one who takes by "due" negotiation of a negotiable document.

On the other hand, where goods are delivered to a factor for sale, even though the factor has made no advances and is limited in his duty to sell for cash, the goods are "entrusted" to him "with actual ... authority ... to sell" under subsection (1)(a) (A.C.A. § 4-7-503(1)(a)), and if he procures a negotiable document of title he can transfer the owner's interest to a purchaser by due negotiation. Further, where the factor is in the business of selling, goods entrusted to him simply for safekeeping or storage may be entrusted under circumstances which give him "apparent authority to ship, store or sell" under subsection (1)(a) (A.C.A. § 4-7-503(1)(a)), or power of disposition under

Section 2-403 (A.C.A. § 4-2-403), 7-205 (A.C.A. § 4-7-205) or 9-307 (A.C.A. § 4-9-307), or under a statute such as the earlier Factors Acts, or under a rule of law giving effect to apparent ownership. See Section 1-103 (A.C.A. § 4-1-103).

Persons having an interest in goods also frequently deliver or entrust them to agents or servants other than factors for the purpose of shipping or warehousing or under circumstances reasonably contemplating such action. Rounding out the case law development under the prior Acts, this Act is clear that such persons assume the full risk that the agent to whom the goods are so delivered may ship or store in breach of duty, take a document to his own order and then proceed to misappropriate it. This Act makes no distinction between possession or mere custody in such situations and finds no exception in the case of larceny by a bailee or the like. The safeguard in such situations lies in the requirement that a due negotiation can occur only "in the regular course of business or financing" and that the purchase be in good faith and without notice. See Section 7-501 (A.C.A. § 4-7-501). Documents of title have no market among the commercially inexperienced and the commercially experienced do not take them without inquiry from persons known to be truck drivers or petty clerks even though such persons purport to be operating in their own names.

Again, where the seller allows a buyer to receive goods under a contract for sale, though as a "conditional delivery" or under "cash sale" terms and on explicit agreement for immediate payment, the buyer thereby acquires power to defeat the seller's interest by transfer of the goods to certain good faith purchasers. See Section 2-403 (A.C.A. § 4-2-403). Both in policy and under the language of subsection (1)(a) (A.C.A. § 4-7-503(1)(a)) that same power must be extended to accomplish the same result if the buyer procures a negotiable document of title to the goods and duly negotiates it.

2. Under subsection (1) (A.C.A. § 4-7-503(1)) a delivery order issued by a person having no right in or power over the goods is ineffective unless the owner acts as provided in subsection (1)(a) or (b) (A.C.A.



§ 4-7-503(1)(a) or (b)). Thus the rights of a transferee of a nonnegotiable warehouse receipt can be defeated by a delivery order subsequently issued by the transferor only if the transferee "delivers or entrusts" to the "person procuring" the delivery order or "acquiesces" in his procurement. Similarly, a second delivery order issued by the same issuer for the same goods will ordinarily be subject to the first, both under this section and under Section 7-402 (A.C.A. § 4-7-402). After a delivery order is validly issued but before it is accepted, it may nevertheless be defeated under subsection (2) (A.C.A. § 4-7-503(2)) in much the same way that the rights of a transferee may be defeated under Section 7-504 (A.C.A. § 4-7-504). For example, a buyer in ordinary course from the issuer may defeat the rights of the holder of a prior delivery order if the bailee receives notification of the buyer's rights before notification of the holder's rights. Section 7-504(2)(b) (A.C.A. § 4-7-504(2)(b)). But an accepted delivery order has the same effect as a document issued by the bailee.

3. Under subsection (3) (A.C.A. § 4-7-503(3)) a bill of lading issued to a freight forwarder is subordinated to the freight forwarder's certificate, since the bill on its face gives notice of the fact that a freight forwarder is in the picture and has in all probability issued a certificate. But the carrier is protected in following the terms of its own bill of lading.

### Comment to § 7-504 (A.C.A. § 4-7-504)

#### *Prior Uniform Statutory Provision:*

Section 34, Uniform Sales Act; Sections 41(b) and 42, Uniform Warehouse Receipts Act; Sections 32(b) and 33, Uniform Bills of Lading Act.

#### *Changes:*

Generally rewritten; Subsection (3) (A.C.A. § 4-7-504(3)) is new.

#### *Purposes of Changes and New Matter:*

1. Under the general principles controlling negotiable documents, it is clear that in the absence of due negotiation a transferor cannot convey greater rights than he himself has, even when the negotiation is formally perfect. This section recognizes the transferor's power to transfer rights which he himself has or has "actual authority to convey." Thus, where a negotia-

#### *Cross References:*

Point 1: Sections 2-403 (A.C.A. § 4-2-403), 7-205 (A.C.A. § 4-7-205), 7-501 (A.C.A. § 4-7-501), 9-307 (A.C.A. § 4-9-307) and 9-309 (A.C.A. § 4-9-309).

Point 2: Sections 7-402 (A.C.A. § 4-7-402) and 7-504 (A.C.A. § 4-7-504).

Point 3: Sections 7-402 (A.C.A. § 4-7-402), 7-403 (A.C.A. § 4-7-403) and 7-404 (A.C.A. § 4-7-404).

#### *Definitional Cross References:*

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Delivery order". Section 7-102 (A.C.A. § 4-7-102).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Duly negotiate". Section 7-501 (A.C.A. § 4-7-501).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

ble document of title is being transferred the operation of the principle of estoppel is not recognized, as contrasted with situations involving the transfer of the goods themselves. (Compare Section 2-403 (A.C.A. § 4-2-403) on good faith purchase of goods.)

A necessary part of the price for the protection of regular dealings with negotiable documents of title is an insistence that no dealing which is in any way irregular shall be recognized as a good faith purchase of the document or of any rights pertaining to it. So, where the transfer of a negotiable document fails as a negotiation because a requisite indorsement is forged or otherwise missing, the purchaser in good faith and for value may be in the anomalous position of having less rights, in part, than if he had purchased

the goods themselves. True, his rights are not subject to defeat by attachment of the goods or surrender of them to his transferor (Contrast subsection (2) (A.C.A. § 4-7-504(2))); but on the other hand, he cannot acquire enforceable rights to control or receive the goods over the bailee's objection merely by giving notice to the bailee. Similarly, a consignee who makes payment to his consignor against a straight bill of lading can thereby acquire the position of a good faith purchaser of goods under provisions of the Article (Chapter) of this Act on Sales (Section 2-403 (A.C.A. § 4-2-403)), whereas the same payment made in good faith against an unindorsed order bill would not have such effect. The appropriate remedy of a purchaser in such a situation is to regularize his status by compelling indorsement of the document (see Section 7-506 (A.C.A. § 4-7-506)).

2. As in the case of transfer — as opposed to “due negotiation” — of negotiable documents, subsection (1) (A.C.A. § 4-7-504(1)) empowers the transferor of a non-negotiable document to transfer only such rights as he himself has or has “actual authority” to convey. In contrast to situations involving the goods themselves the operation of estoppel or agency principles is not here recognized to enable the transferor to convey greater rights than he actually has. Subsection (2) (A.C.A. § 4-7-504(2)) makes it clear, however, that the transferee of a nonnegotiable document may acquire rights greater in some respects than those of his transferor by giving notice of the transfer to the bailee.

3. Subsection (3) (A.C.A. § 4-7-504(3)) is in part reiteration of the carrier's immunity from liability if it honors instructions of the consignor to divert, but there is added a provision protecting the title of the substituted consignee if the latter is a buyer in ordinary course of business. A typical situation would be where a manufacturer, having shipped a lot of standardized goods to A on nonnegotiable bill of lading, diverts the goods to customer B who pays for them. Under orthodox passage-of-title-by-appropriation doctrine A might reclaim the goods from B. However, no consideration of commercial policy supports this involvement of an innocent third party in the default of the manufacturer on his contract to A; and the common commercial practice of diverting goods in

transit suggests a trade understanding in accordance with this subsection.

4. Subsection (4) (A.C.A. § 4-7-504(4)) gives the carrier an express right to indemnity where he honors a seller's request to stop delivery.

5. Section 1-201(27) (A.C.A. § 4-1-201(27)) gives the bailee protection, if due diligence is exercised, similar to that found in the third paragraph of Section 33, Uniform Bills of Lading Act, where the bailee's organization has not had time to act on a notification.

#### *Cross References:*

Point 1: Sections 2-403 (A.C.A. § 4-2-403) and 7-506 (A.C.A. § 4-7-506).

Point 2: Section 2-403 (A.C.A. § 4-2-403).

Point 3: Sections 7-303 (A.C.A. § 4-7-303) and 7-403(1)(e) (A.C.A. § 4-7-403(1)(e)).

Point 4: Sections 2-705 (A.C.A. § 4-2-705) and 7-403(1)(d) (A.C.A. § 4-7-403(1)(d)).

#### *Definitional Cross References:*

“Bailee”. Section 7-102 (A.C.A. § 4-7-102).

“Bill of lading”. Section 1-201 (A.C.A. § 4-1-201).

“Buyer in ordinary course of business”. Section 1-201 (A.C.A. § 4-1-201).

“Consignee”. Section 7-102 (A.C.A. § 4-7-102).

“Consignor”. Section 7-102 (A.C.A. § 4-7-102).

“Creditor”. Section 1-201 (A.C.A. § 4-1-201).

“Delivery”. Section 1-201 (A.C.A. § 4-1-201).

“Document”. Section 7-102 (A.C.A. § 4-7-102).

“Duly negotiate”. Section 7-501 (A.C.A. § 4-7-501).

“Good faith”. Section 1-201 (A.C.A. § 4-1-201).

“Goods”. Section 7-102 (A.C.A. § 4-7-102).

“Honor”. Section 1-201 (A.C.A. § 4-1-201).

“Notification”. Section 1-201 (A.C.A. § 4-1-201).

“Purchaser”. Section 1-201 (A.C.A. § 4-1-201).

“Rights”. Section 1-201 (A.C.A. § 4-1-201).



**Comment to § 7-505 (A.C.A. § 4-7-505)***Prior Uniform Statutory Provision:*

Section 37, Uniform Sales Act; Section 45, Uniform Warehouse Receipts Act; Section 36, Uniform Bills of Lading Act.

*Changes:*

No substantial change.

*Purposes of Changes:*

The indorsement of a document of title is generally understood to be directed towards perfecting the transferee's rights rather than towards assuming additional obligations. The language of the present section, however, does not preclude the one case in which an indorsement given for value guarantees future action, namely, that in which the bailee has not yet become liable upon the document at the time of the indorsement. Under such circumstances the indorser, of course, en-

gages that appropriate honor of the document by the bailee will occur. See Section 7-502(1)(d) (A.C.A. § 4-7-502(1)(d)) as to negotiable delivery orders. However, even in such a case, once the bailee attorns to the transferee, the indorser's obligation has been fulfilled and the policy of this section excludes any continuing obligation on the part of the indorser for the bailee's ultimate actual performance.

*Cross Reference:*

Section 7-502 (A.C.A. § 4-7-502).

*Definitional Cross References:*

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-506 (A.C.A. § 4-7-506)***Prior Uniform Statutory Provision:*

Section 35, Uniform Sales Act; Section 43, Uniform Warehouse Receipts Act; Section 34, Uniform Bills of Lading Act.

*Changes:*

Consolidated and rewritten; former requirement that transfer be "for value" eliminated.

*Purposes of Changes:*

1. From a commercial point of view the intention to transfer a negotiable document of title which requires an indorsement for its transfer, is incompatible with an intention to withhold such indorsement and so defeat the effective use of the document. This position is sustained by the absence of any reported case applying the prior provisions in almost forty years of decisions. Further, the preceding section and the Comment thereto make it clear that an indorsement generally imposes no responsibility on the indorser.

2. Although this section provides that delivery of a document of title without the necessary indorsement is effective as a

transfer, the transferee, of course, has not regularized his position until such indorsement is supplied. Until this is done he cannot claim rights under due negotiation within the requirements of this Article (Chapter) (subsection (4) of Section 7-501 (A.C.A. § 4-7-501(4))) on "due negotiation." Similarly, despite the transfer to him of his transferor's title, he cannot demand the goods from the bailee until the negotiation has been completed and the document is in proper form for surrender. See Section 7-403(2) (A.C.A. § 4-7-403(2)).

*Cross References:*

Point 1: Section 7-505 (A.C.A. § 4-7-505).

Point 2: Sections 7-501(4) (A.C.A. § 4-7-501(4)) and 7-403(2) (A.C.A. § 4-7-403(2)).

*Definitional Cross References:*

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-507 (A.C.A. § 4-7-507)***Prior Uniform Statutory Provision:*

Section 36, Uniform Sales Act; Section 44, Uniform Warehouse Receipts Act; Section 35, Uniform Bills of Lading Act.

*Changes:*

Consolidated and rewritten without change in policy.

*Purposes of Changes:*

1. This section omits provisions of the prior acts on warranties as to the goods as unnecessary and incomplete. It is unnecessary because such warranties derive from the contract of sale and not from the transfer of the documents. The fact that transfer of control occurs by way of a document of title does not limit or displace the ordinary obligations of a seller. The former provision, moreover, was incomplete because it did not expressly include all of the warranties which might rest upon a seller under such circumstances. This Act handles the problem by means of the precautionary reference to "any warranty made in selling the goods." If the transfer of documents attends or follows the making of a contract for the sale of goods, the general obligations on warran-

ties as to the goods (Sections 2-312 (A.C.A. § 4-2-312) through 2-318 (A.C.A. § 4-2-318)) are brought to bear as well as the special warranties under this section.

2. The limited warranties of a delivering or collecting intermediary are stated in Section 7-508 (A.C.A. § 4-7-508).

*Cross References:*

Point 1: Sections 2-312 (A.C.A. § 4-2-312) through 2-318 (A.C.A. § 4-2-318).

Point 2: Section 7-508 (A.C.A. § 4-7-508).

*Definitional Cross References:*

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Genuine". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-508 (A.C.A. § 4-7-508)***Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. To state the limited warranties given with respect to the documents accompanying a documentary draft.

2. In warranting its authority a bank only warrants its authority from its transferor. See Section 4-203 (A.C.A. § 4-4-203). It does not warrant the genuineness or effectiveness of the document. Compare Section 7-507 (A.C.A. § 4-7-507).

3. Other duties and rights of banks handling documentary drafts for collection are stated in Article 4 (Chapter 4), Part 5.

*Cross References:*

Sections 4-203 (A.C.A. § 4-4-203) and 7-507 (A.C.A. § 4-7-507), 4-501 (A.C.A. § 4-4-501) through 4-504 (A.C.A. § 4-4-504).

*Definitional Cross References:*

"Collecting bank". Section 4-105 (A.C.A. § 4-4-105).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Draft". Section 5-103 (A.C.A. § 4-5-103).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).



**Comment to § 7-509 (A.C.A. § 4-7-509)**

*Prior Uniform Statutory Provision:*  
None.

*Cross References:*  
Articles 2 and 5 (Chapters 2 and 5).

*Purposes:*

To cross-refer to the Articles (Chapters) of this Act which deal with the substantive issues of the type of document of title required under the contract entered into by the parties.

*Definitional Cross References:*

"Contract for sale". Section 2-106 (A.C.A. § 4-2-106).

"Document". Section 7-102 (A.C.A. § 4-7-102).

**Comment to § 7-601 (A.C.A. § 4-7-601)***Prior Uniform Statutory Provision:*

Section 14, Uniform Warehouse Receipts Act; Section 17, Uniform Bills of Lading Act.

*Changes:*

General Revision. Principal innovations include: affirmation of bailee's privilege to deliver to claimant without resort to judicial proceedings if the bailee acts in good faith and is willing to take the full risk of loss in case the lost document turns up in the hands of an innocent purchaser; explicit authorization to the court to order bailee to issue a substitute document rather than make physical delivery of the goods; inclusion of "stolen" as well as lost documents; extension of section to nonnegotiable documents.

*Purposes of Changes:*

The purposes of the changes insofar as they are not self-evident are as follows:

1. As to the bailee's privilege to deliver without court order, doubt had arisen as to the propriety of such action under Section 54 of the Uniform Warehouse Receipts Act, which made it a crime to deliver goods covered by negotiable receipts without taking up the receipts "except in the cases provided for in Section 14" (the lost receipts section). This has been interpreted by one court as exempting from criminal liability only if the judicial procedure of Section 14 was followed. *Dahl v. Winter-Truesdell-Diercks Co.*, 61 N.D. 84, 237 N.W. 202 (1931). Although the criminal provisions are not being re-enacted in this Act (and the Uniform Bills of Lading Act never did include such a criminal provision), it seems advisable to clarify the legality of the well established commercial practice of bailees to make delivery where they are satisfied that the

claimant is the person entitled under a lost document. Since the bailee remains liable only on the document in such cases, he will usually insist that the claimant provide an indemnity bond.

2. The old acts provide only for compulsory delivery of goods; this Section provides also for compulsory issuance of a substitute document. If continuance of the bailment is desirable there is no reason to require the goods to be withdrawn and redeposited in order to secure a negotiable document. The present acts would probably be so interpreted. Section 20 of the Federal Warehouse Act and some state laws expressly require issuance of a new receipt on proof of loss and posting of bond.

3. Claimants on nonnegotiable instruments are permitted to avail themselves of this procedure because straight bills of lading sometimes contain provisions that the goods shall not be delivered except upon production of the bill. If the carrier should choose to insist upon production of the bill, the consignee should have some means of compelling delivery on satisfactory proof of entitlement.

Ordinarily no security would be necessary to indemnify a bailee in delivering to the person named in a nonnegotiable document. But disputes as to negotiability may arise, in which case if there is a reasonable doubt on the point that the bailee should be protected against the possibility that the missing document would, in the hands of an innocent purchaser for value, be held negotiable.

4. It seems unnecessary to state, as do the present acts, that the court shall act "on satisfactory proof of such loss or destruction." The right of action created by the section is conditioned on a document

being lost, stolen or destroyed. Plaintiff must of course bring himself within the section. There is nothing in the language of the old acts to suggest that they intended to impose anything but the normal proof on the plaintiff in such proceedings.

5. Subsection (2) (A.C.A. § 4-7-601(2)) makes it clear that after delivery without court order the bailee remains liable for actual damages. Liability for conversion is provided where the delivery is dishonest, but excluded where a filed classification or tariff is followed in good faith, or where the described bond is posted in good faith and no classification or tariff is filed. Liability for conversion in other cases is left to judicial decision.

*Definitional Cross References:*

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Bill of lading". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Warehouse receipt". Section 1-201 (A.C.A. § 4-1-201).

"Warehouseman". Section 7-102 (A.C.A. § 4-7-102).

**Comment to § 7-602 (A.C.A. § 4-7-602)**

*Prior Uniform Statutory Provisions:*

Section 25, Uniform Warehouse Receipts Act; Section 24, Uniform Bills of Lading Act.

*Changes:*

Consolidated and rewritten.

*Purposes of Changes:*

1. The purpose of the section is to protect the bailee from conflicting claims of the document holder and the judgment creditors of the person who deposited the goods. The rights of the former prevail unless, in effect, the judgment creditors immobilize the negotiable document. However, if the document was issued upon deposit of the goods by a person who had no power to dispose of the goods so that the document is ineffective to pass title, judgment liens are valid to the extent of the debtor's interest in the goods.

2. The last sentence covers the possibility that the holder of a document who has been enjoined from negotiating it will vi-

olate the injunction by negotiating to an innocent purchaser for value. In such case the lien will be defeated.

*Cross Reference:*

Point 1: Section 7-503 (A.C.A. § 4-7-503).

*Definitional Cross References:*

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 7-102 (A.C.A. § 4-7-102).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

**Comment to § 7-603 (A.C.A. § 4-7-603)**

*Prior Uniform Statutory Provision:*

Sections 16 and 17, Uniform Warehouse

Receipts Act; Sections 20 and 21, Uniform Bills of Lading Act.



*Changes:*

Consolidation without substantial change.

*Purposes of Changes:*

The section enables a bailee faced with conflicting claims to the goods to compel the claimants to litigate their claims with each other rather than with him.

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Bailee". Section 7-102 (A.C.A. § 4-7-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 7-102 (A.C.A. § 4-7-102).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable time". Section 1-204 (A.C.A. § 4-1-204).

Due to the substantial revision of Article 8 (Chapter 8) and the comments thereto, the updated 1977 commentary was used in place of the original commentary for each section which had revised commentary.

## ARTICLE 8

## (A.C.A. § 4-8-101 ET SEQ.)

**A.C.R.C. Notes.** This article was repealed and replaced by a revised Article 8

by Acts 1995, No. 425. This commentary is applicable to the repealed article.

**Comment to § 8-101 (A.C.A. § 4-8-101)***Purposes:*

This Article (Chapter) sets forth certain rights and duties of the issuers of and the parties that deal with investment securities, both certificated and uncertificated. Unlike a corporation code, it does not set forth general rules defining property rights that accrue to holders of securities. And unlike a Blue Sky statute it does not set forth specific requirements for disclosing to the public the nature of the property interest that is the security. Rather it sets forth rules relative to the transfer of the rights that constitute securities and to the establishment of those rights against the issuer and other parties.

As is true with respect to all other Articles (Chapters) of the Code, parties

may by agreement create rights and duties between themselves that vary from those set forth in this Article (Chapter). Section 1-102(3) (A.C.A. § 4-1-102(3)). But prejudice to the rights of those not party to the agreement is limited by Code provisions (e.g., Sections 8-313 (A.C.A. § 4-8-313) and 8-321 (A.C.A. § 4-8-321)) as well as by general legal principles that supplement the Code. See Section 1-103 (A.C.A. § 4-1-103) and Comment 2 to Section 1-102 (A.C.A. § 4-1-102).

This Article (Chapter) does not purport to determine whether a particular issue of securities should be represented by certificates, in whole or in part. That determination is left to the parties involved, subject to federal and state law.

**Comment to § 8-102 (A.C.A. § 4-8-102)\****Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. This is Article 8's (Chapter 8's) definitional Section. It is supplemented generally by the definitions in Article 1 (Chapter 1) and in particular matters is supplemented by definitions in other Articles (Chapters). Subsection (5) (A.C.A. § 4-8-102(5)) enumerates several important supplementary definitions and their locations in the Code.

2. Subsection (1) (A.C.A. § 4-8-102(1)) defines "security," the basic term of this section. Paragraphs (a) and (b) (A.C.A. § 4-8-102(1)(a) and (b)) respectively define "certificated security" and "uncertificated security," and paragraph (c) (A.C.A. § 4-8-102(1)(c)) states that the term "security" comprises both. These definitions are functional rather than formal. At the core is the notion that a security is a share or participation in an enterprise or an obligation that is of a type commonly traded in organized markets for such interests or is commonly recognized as a medium for investment. The ambit of the

definition will change as "securities" trading practices evolve to include or exclude new property interests. It is believed that the definition will cover anything which securities markets, including not only the organized exchanges but as well the "over-the-counter" markets, are likely to regard as suitable for trading. For example, transferable warrants evidencing rights to subscribe for shares in a corporation will normally be "certificated securities" within the definition, since they (a) are issued in bearer or registered form, (b) are of a type commonly dealt in on securities markets, (c) constitute a class or series of instruments, and (d) evidence an obligation of the issuer, namely the obligation to honor the warrant upon its due exercise and issue shares accordingly.

Notice that the definition of uncertificated security does not include the phrase "or commonly recognized in any area in which it is issued or dealt in as a medium for investment." Since there is no requirement of representation by an instrument, a great many interests that might be regarded as media for invest-



ment would be classified as securities under the umbrella of the omitted phrase. For example, interests such as bank checking and savings accounts are intended to be excluded from the definition because they are not commonly traded; but since those accounts are commonly recognized as media for investment, the omitted language might bring them within the scope of the definition.

Interests such as the stock of closely-held corporations, although they are not actually traded upon securities exchanges, are intended to be included within the definitions of both certificated and uncertificated securities by the inclusion of interests "of a type" commonly traded in those markets. See paragraphs (1)(a)(ii) (A.C.A. § 4-8-102(1)(a)(ii)) and (1)(b)(ii) (A.C.A. § 4-8-102(1)(b)(ii)).

The second sentence of (1)(c) (A.C.A. § 4-8-102(1)(c)) is intended to eliminate confusion arising from the fact that certificated securities are alternately viewed as the actual pieces of paper and the interests they represent. The final sentence of (1)(c) (A.C.A. § 4-8-102(1)(c)) is to recognize that an issuer that nominally issues certificated securities but does not normally send the certificates to the owners is functionally identical to the issuer of uncertificated securities and should be guided by the same rules.

3. The consequence of determining that an interest is a "security" is that this Article (Chapter) will provide the relative rights of issuers, owners, purchasers and creditors as to transfer of rights, notice of claims, registration of interests, etc. This definition has no bearing upon whether an interest is a "security" for purposes of federal securities laws. By the same token the definitions of "securities" for the purposes of those laws has no bearing upon whether an interest is a security within the definition of this Article (Chapter).

4. A certificated security is a negotiable instrument (Section 8-105 (A.C.A. § 4-8-

105)) but is nonetheless governed by this Article (Chapter) rather than Article 3 (Chapter 3). A critical distinction between certificated securities and other negotiable instruments is that one indorsing a security does not undertake the issuer's obligation or make any warranty that the issuer will honor the underlying obligation. One indorsing other negotiable instruments becomes secondarily liable on the underlying obligation.

5. The definition of "clearing corporation" in subsection (3) (A.C.A. § 4-8-102(3)) reflects the fact that a 1975 amendment to the Securities Exchange Act provides for registration of "clearing agencies" with the Securities and Exchange Commission.

#### *Cross Reference:*

Section 3-103 (A.C.A. § 4-3-103).

#### *Definitional Cross References:*

"Bearer". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 26(8-102), to incorporate the 1962 changes to this Uniform Commercial Code section. It was then amended by Acts 1973, No. 259, § 1, to incorporate the 1973 changes to this Uniform Commercial Code section, and then it was amended to by Acts 1985, No. 514, § 3(8-102), to incorporate the 1977 changes to this Uniform Commercial Code section.

#### **Comment to § 8-103 (A.C.A. § 4-8-103)\***

##### *Prior Uniform Statutory Provision:*

Section 15, Uniform Stock Transfer Act.

##### *Purposes:*

1. The rule of Section 15 of the Uniform Stock Transfer Act is made applicable to

all securities covered by the Article (Chapter). An analogous rule as to restrictions on transfer imposed by the issuer appears at Section 8-204 (A.C.A. § 4-8-204). Compare also Section 8-202 (A.C.A. § 4-8-202). This section differs from those two

sections in that the purchaser's knowledge of the issuer's claim is irrelevant.

"Noted" makes clear that the text of the lien provisions need not be set forth in full. However, this would not override a provision of an applicable corporation code requiring statement in *haec verba*.

2. The purchaser of an uncertificated security is charged with notice of all provisions in the initial transaction statement, whether or not it is sent to him personally. Similarly, one who takes a certificated security is charged with notice of all provisions noted on the certificate whether or not he actually receives the certificate. When a purchaser takes a security under circumstances in which no initial transaction statement is sent to him by the issuer and no certificated security is delivered to him, he must look to the person to whom a transfer or pledge of the uncertificated security has been registered or the person in possession of the certificated security for the appropriate notice or absence thereof. If the purchaser is not notified of a lien he may have a right of action for breach of transfer warranties. See Section 8-306 (A.C.A. § 4-8-306).

Compare Section 8-202 (A.C.A. § 4-8-202) and its Comment 1.

*Cross Reference:*

Sections 8-202 (A.C.A. § 4-8-202) and 8-204 (A.C.A. § 4-8-204).

*Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Conspicuous". Section 1-201 (A.C.A. § 4-1-201).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3 (8-103), to incorporate the 1977 changes to the Uniform Commercial Code section.

**Comment to § 8-104 (A.C.A. § 4-8-104)\***

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. Deeply embedded in corporation law is the conception that "corporate power" to issue securities stems from the statute, either general or special, under which the corporation is organized. Corporations codes universally require that the charter or articles of incorporation state, at least as to capital shares, maximum limits in terms of number of shares or total dollar capital. Historically, special incorporation statutes are similarly drawn and sometimes similarly limit the face amount of authorized debt securities. The theory is that issue of securities in excess of the authorized amounts is prohibited. See, for example, *McWilliams v. Geddes & Moss Undertaking Co.*, 169 So. 894 (1936, La.); *Crawford v. Twin City Oil Co.*, 216 Ala. 216, 113 So. 61 (1927); *New York and New Haven R.R. Co. v. Schuyler*, 34 N.Y. 30 (1865). This conception persists despite modern corporation codes under which, by action of directors and stockholders, addi-

tional shares can be authorized by charter amendment and thereafter issued. This section does not give a person entitled to validation, issue or reissue of a security, the right to compel amendment of the charter to authorize additional shares. Therefore, in a case where issue of an additional security would require charter amendment, the plaintiff is limited to the two alternate remedies set forth in paragraphs (a) and (b) of subsection (1) (A.C.A. § 4-8-104(1)(a) and (b)).

2. Where an identical security is reasonably available for purchase, whether because traded on an organized market, or because one or more security owners may be willing to sell at a not unreasonable price, the issuer, although unable to issue additional shares, will be able to purchase them and may be compelled to follow that procedure. *West v. Tintic Standard Mining Co.*, 71 Utah 158, 263 P. 490 (1928).

Paragraph (1)(a) (A.C.A. § 4-8-104(1)(a)) gives the issuer the choice to transfer either a certificated or an uncertificated security. As a practical mat-



ter the issuer will have the choice only when the securities of the issue involved are partly certificated and partly uncertificated; and in those circumstances section 8-407 (A.C.A. § 4-8-407) gives the owner (or registered pledgee) the right to choose the form of the security. Thus the issuer likely will transfer a security of the form requested by the person entitled to the security.

3. The right to recover damages from an issuer who has permitted an overissue to occur is well settled. *New York and New Haven R.R. Co. v. Schuyler*, 34 N.Y. 30 (1865). The measure of such damages, however, has been open to the question, some courts basing them upon the value of the stock at the time registration is refused; some upon the value at the time of trial; and some upon the highest value between the time of refusal and the time of trial. *Allen v. South Boston R. Co.*, 150 Mass. 200, 22 N.E. 917, 5 L.R.A. 716, 15 Am.St.Rep. 185 (1889); *Commercial Bank v. Kortright*, 22 Wend. (N.Y.) 348 (1839). The purchase price of the security to the last purchaser who gave value for it is here adopted as being the fairest means of reducing the possibility of speculation by the purchaser. Interest may be recovered as the best available measure of compensation for delay.

4. This section modifies and controls the rules otherwise laid down in this Article (Chapter) as to the validation and issue of securities. The particular sections so modified are listed in the cross-references.

*Cross References:*

Point 4: See Sections 8-202 (A.C.A. § 4-8-202), 8-205 (A.C.A. § 4-8-205), 8-206 (A.C.A. § 4-8-206), 8-208 (A.C.A. § 4-8-208), 8-311 (A.C.A. § 4-8-311) and Part 4 of this Article (Chapter).

*Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-104), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-105 (A.C.A. § 4-8-105)\***

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. Although certificated securities are negotiable instruments, this Article (Chapter) and not Article 3 (Chapter 3) provides the rights and duties relative to such instruments. See Sections 8-102(1)(c) (A.C.A. § 4-8-102(1)(c)) and 3-103(1) (A.C.A. § 4-3-103(1)). But in subsection (3) of this section (A.C.A. § 4-8-105(3)) the particular rules stated in Section 3-307 (A.C.A. § 4-3-307) for the negotiable instruments governed by Article 3 (Chapter 3) are adapted to certificated securities. Further those rules are adopted with respect to signatures on initial transaction statements, although subsection (2) (A.C.A. § 4-8-105(2)) makes clear that such statements are not negotiable instruments.

2. Paragraph (3)(d) (A.C.A. § 4-8-105(3)(d)) makes clear that the effect of establishing the validity of signatures on an initial transaction statement is to create a presumption that the facts stated therein were true as of the time it was issued. The issuer is free to show that later events — e.g., a subsequent transfer — changed the stated facts.

3. "Any action on a security" includes any action or proceeding brought against the issuer to enforce a right or interest that is part of the security — e.g., to collect principal or interest or a dividend, or to establish a right to vote or to receive a new security under an exchange offer or plan of reorganization.

*Cross References:*

Sections 3-103 (A.C.A. § 4-3-103), 3-307 (A.C.A. § 4-3-307), 8-202 (A.C.A. § 4-8-202), 8-301 (A.C.A. § 4-8-301).

*Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-105), to incorporate the 1977 changes to this Uniform Commercial Code section.

### **Comment to § 8-106 (A.C.A. § 4-8-106)\***

*Prior Uniform Statutory Provision:*

None.

*Purpose:*

1. This section states a special rule for conflicts of laws relating to certain matters covered by this Article (Chapter). Except as provided in this section, the generally applicable conflicts rules stated in Section 1-105 (A.C.A. § 4-1-105) apply to Article 8 (Chapter 8).

2. Generally speaking, this section makes the law, including the conflict of laws rules, of the jurisdiction in which the issuer is organized applicable to determine the rights and obligations of the issuer with respect to security. Further, the effectiveness of registration by the issuer is to be governed by the law of the jurisdiction in which the issuer is organized. Thus whenever an uncertificated security is transferred through registration on the issuer's records, Section 8-313(1)(b) (A.C.A. § 4-8-313(1)(b)), this section provides the choice of law rule as to the effectiveness of the registration to effect the transfer. Similarly, the effectiveness of a registration on the issuer's records to create and perfect a security interest in uncertificated securities (see Section 8-321 (A.C.A. § 4-8-321)) is within the ambit of this section.

It is significant that this section makes applicable the conflict of laws rules as well as the substantive law of the jurisdiction in which the issuer is organized. Because of this provision many matters related to the registration of transfer — for example,

the appointment of a guardian for an incompetent person and the existence of agency relations — may be governed by the substantive law of a jurisdiction other than that in which the issuer is organized.

Any transfer of securities that is not effected through registration on the issuer's records is subject to the law provided by general choice of law rules. Transfers (including pledges) of certificated securities are not effected by registration on the issuer's records, and thus are subject to general choice of law rules. Similarly, some transfers of uncertificated securities are not covered by this section. See Section 8-313(1)(d) and (f)-(j) (A.C.A. § 4-8-313(1)(d) and (f)-(j)).

*Cross References:*

Sections 1-105 (A.C.A. § 4-1-105) and 8-202 (A.C.A. § 4-8-202) and Part 4 of this Article (Chapter).

*Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-106), to incorporate the 1977 changes to this Uniform Commercial Code section.

### **Comment to § 8-107 (A.C.A. § 4-8-107)\***

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. The rights and interests that consti-



tute securities of the same issue are "fungible". Section 1-201(17) (A.C.A. § 4-1-201(17)). This is true of both certificated and uncertificated securities. Subsection (1) (A.C.A. § 4-8-107(1)) states the generally accepted legal consequences of such fungibility. "Unless otherwise agreed", the seller, bailee, broker or other "person obligated to transfer securities" need not transfer any specific instrument, but may select (e.g., from a "fungible bulk" (Section 8-313(2) (A.C.A. § 4-8-313(2))) any security of the proper issue, in bearer form or appropriately registered or indorsed or may transfer an uncertificated security of the same issue.

Rules of the organized markets limiting the forms in which securities are transferable in transactions on such markets are matters "otherwise agreed". Cases such as *Parsons v. Martin*, 77 Mass. (11 Gray) 111 (1858) and *Rumery v. Brooks*, 205 App.Div. 283, 199 N.Y.Supp. 517 (1st Dept.1923), holding a broker liable for conversion if he registers transfer of a customer's securities held in "cash account" out of the customer's name or tenders on demand for delivery a different though equivalent security, are rejected. However, this Act does not enlarge the rights of a broker as to such securities so as to permit him without the customer's consent to pledge them for his own indebtedness, and he may properly do with securities held in a "margin account" to the extent he has acquired a lien for advances. The distinction is carefully preserved in statute (e.g., N.Y.Penal Law § 956) and case law. In *re Mills*, 125 App.Div. 730, 113 N.Y.Supp. 314 (1st Dept.1908).

2. Subsection (2) (A.C.A. § 4-8-107(2)) is designed to follow the dictum in *Agar v.*

*Orda*, 264 N.Y. 248, 190 N.E. 479 (1934) in this context. Paragraph (c) (A.C.A. § 4-8-107(2)(c)) is applicable where for example (i) the securities are those of a "closely-held" corporation not dealt in on any organized market; or (ii) because of the necessity for compliance with the registration requirements of the Securities Act of 1933 or other regulatory provisions or procedures prior to offering the particular securities on the market substantial delay and expense would be involved. The approval of these particular remedies does not constitute disapproval of other remedies that may exist under other rules of law. Section 1-103 (A.C.A. § 4-1-103).

#### *Cross References:*

Sections 1-103 (A.C.A. § 4-1-103); 2-708 (A.C.A. § 4-2-708); 2-709 (A.C.A. § 4-2-709); 8-313 (A.C.A. § 4-8-313); 8-319 (A.C.A. § 4-8-319).

#### *Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-107), to incorporate the 1977 changes to the Uniform Commercial Code section.

### **Comment to § 8-108 (A.C.A. § 4-8-108)\***

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

This section introduces the concept of the registered pledge of uncertificated securities. The term "pledge" is used, notwithstanding the absence of physical delivery, because it reflects common terminology employed in connection with security interests in investment securities. Note that the same term has been used in Section 8-320 (A.C.A. § 4-8-320)

to describe the security interest created by book entry made by a securities depository. The rights of a registered pledgee, set forth in other sections (particularly Section 8-207 (A.C.A. § 4-8-207)), are intended to resemble, as closely as possible, the rights of a pledgee of a certificated security who retains possession of the pledged security without reregistration. Although the registration of pledge requires communication to the issue, no details of the security agreement between

the debtor and the secured party need be disclosed.

There is no provision for the registration of more than one pledge at a time. This limits the burden on issuers and insulates them from problems of conflicting priorities and the like. The registration of pledge is only one among several methods of creating security interests under Section 8-313(1) (A.C.A. § 4-8-313(1)), and other methods can be effectively employed to create security interests junior to that of the registered pledgee or even first security interests if, for some reason, the use of the registered pledge mechanism is inadvisable. See Section 8-321 (A.C.A. § 4-8-321), which deals comprehensively with security interests and incorporates the transfer rules of Section 8-313(1) (A.C.A. § 4-8-313(1)) by reference.

The third sentence makes it clear that the registered owner, and not the registered pledgee, is the person in whose name an uncertificated security is registered as, for example, to determine how an unsecured creditor may reach his debtor's

interest under Section 8-317(2) (A.C.A. § 4-8-317(2)). The registration of release, in effect, nullifies the registration of the pledge, and is functionally equivalent to the redelivery of a pledged certificated security to the pledgor.

*Cross References:*

Sections 8-207 (A.C.A. § 4-8-207); 8-321 (A.C.A. § 4-8-321); 8-401 (A.C.A. § 4-8-401).

*Definitional Cross References:*

"Secured Party". Section 9-105 (A.C.A. § 4-9-105).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Security Interest". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-108), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-201 (A.C.A. § 4-8-201)\***

*Prior Uniform Statutory Provision:*

Sections 29, 60, 61, and 62, Uniform Negotiable Instruments Law.

*Purposes:*

1. Part 2 (Subchapter 2) of Article 8 (Chapter 8) describes the rights and duties of an "issuer" of a security. It is generally understood that an "issuer" is the one who creates the property interest that is a "security" and who thereby incurs obligations to purchasers of that interest. This section provides the criteria for determining whether a person has incurred the obligations — and gained the rights — given to an issuer in this Article (Chapter). Numerous rights and obligations arise from sources other than Article 8 (Chapter 8). This section does not determine whether a person is an "issuer" for purposes of those sources of law.

2. Paragraph (1)(a) (A.C.A. § 4-8-201(1)(a)) makes a person an "issuer" for purposes of this Article (Chapter) if he authorizes the placing of his name on a certificate intending that it should be a certificated security (Section 8-102(1)(a) (A.C.A. § 4-8-102(1)(a))). This paragraph

bears a close relationship to Section 8-102(1)(a) (A.C.A. § 4-8-102(1)(a)), which describes the property interests that may constitute a "certificated security." The latter section describes those interests in terms of rights against "the issuer," while this section defines the issuer in terms of authorizing the placing of a name on a "certificated security." The effect is to add to the definition of "certificated security" the requirement that it bear the authorized name of the person creating the property interests. Thus, if a certificate bears the unauthorized name of the purported issuer, the purported issuer is not an "issuer" within this Article (Chapter); and the certificate is not a "certificated security." See Sections 8-202(3) (A.C.A. § 4-8-202(3)) and its Comment 4. Section 8-205 (A.C.A. § 4-8-205) describes the circumstances in which will be treated as if he were a true "issuer" despite the absence of his authorized signature.

3. Read in conjunction with the definition of "uncertificated security" in Section 8-102(1)(b) (A.C.A. § 4-8-102(1)(b)), paragraph (1)(b) (A.C.A. § 4-8-201(1)(b)) makes a person an "issuer" if he creates,



and maintains books for the registration of ownership of, property interests that fit within the definition of an uncertificated security.

4. Subsection (2) (A.C.A. § 4-8-201(2)) distinguishes the obligations of a guarantor as issuer from those of the principal obligor. However, it does not exempt the guarantor from the impact of subsection (4) of Section 8-202 (A.C.A. § 4-8-202(4)). Whether or not the obligation of the guarantor is noted on the security or initial transaction statement (Section 8-408(4) (A.C.A. § 4-8-408(4))) is immaterial. Typically, guarantors are parent corporations, or stand in some similar relationship to the principal obligor. If that relationship existed at the time the security originally was issued, the guaranty probably would be noted on the security or initial transaction statement. However, if the relationship arose afterward — e.g., through a purchase of stock or properties, or through merger or consolidation — probably the notation would not be made. Nonetheless, the holder of the security is entitled to the benefit of the obligation of the guarantor.

5. Subsection (3) (A.C.A. § 4-8-201(3)) narrows the definition of “issuer” for purposes of Part 4 of this Article (Chapter)

(registration of transfer). It is supplemented by Section 8-406 (A.C.A. § 4-8-406).

*Cross References:*

Points 1, 2, and 3: Sections 8-102 (A.C.A. § 4-8-102), 8-202 (A.C.A. § 4-8-202), and 8-205 (A.C.A. § 4-8-205).

Point 4: Section 8-202 (A.C.A. § 4-8-202).

Point 5: Part (Subchapter) 4 of this Article (Chapter).

*Definitional Cross References:*

“Certificated Security”. Section 8-102 (A.C.A. § 4-8-102).

“Person”. Section 1-201 (A.C.A. § 4-1-201).

“Rights”. Section 1-201 (A.C.A. § 4-1-201).

“Security”. Section 8-102 (A.C.A. § 4-8-102).

“Uncertificated Security”. Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-201), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-202 (A.C.A. § 4-8-202)\***

*Prior Uniform Statutory Provisions:*

Sections 16, 23, 28, 56, 57, 60, 61, 62, Uniform Negotiable Instruments Law.

*Purposes:*

1. A purchaser must have some method of learning the terms of the security he is purchasing. The printing on the certificate or on the initial transaction statement (“ITS”) is designed to notify the purchaser of those terms. If he purchases without examining the certificate or ITS, he does so at his peril, since he is charged with notice of the terms stated thereon.

Some methods of transferring a security do not involve the actual delivery of a certificate or the sending of an ITS to the actual purchaser. See Section 8-313(1)(c)-(j) (A.C.A. § 4-8-313(1)(c)-(j)). The situations in which these methods of transfer will be used can be divided into two categories — those in which an intermediary takes a transfer for his principal and those in which a bailee “holding” a security effects a transfer by receiving notice

of, or sending acknowledgment of, the purchase. In either type of situation the purchaser will be charged with notice of all terms stated on the certificate if the security is certificated or, if the security is uncertificated, with notice of all terms stated in the ITS sent to the registered owner or registered pledgee. For example, suppose that Customer purchases an uncertificated security that is already registered in the name of his broker. Customer is content to allow the security to remain registered in Broker’s name, so that Customer never receives an ITS. Customer is charged with notice of the terms stated on the ITS sent to Broker when Broker became the registered owner. Or suppose that Purchaser buys a certificated security and the transfer is effected not by delivering the certificate but by having the Bailee, who holds the security, acknowledge that he holds for Purchaser. Purchaser is charged with notice of the terms written on the certificate.

It is apparent that in these situations a

purchaser must rely upon the intermediary or bailee who "holds" the security for him.

2. Subsection (1)(c) (A.C.A. § 4-8-202(1)(c)) states, in accordance with the prevailing case law, the right of the issuer (who prepares the text of the security or statement) to include terms incorporated by adequate reference to an extrinsic source, so long as the terms so incorporated do not conflict with the stated terms. Thus the standard practice of referring in a bond or debenture to the trust indenture under which it is issued without spelling out its necessarily complex and lengthy provisions is approved. Every stock certificate or ITS will refer in some manner to the charter or articles of incorporation of the issuer. At least where there is more than one class of stock authorized, applicable corporation codes specifically require a statement or summary as to preferences, voting powers and the like. References to constitutions, statutes, ordinances, rules, regulations or orders are not so common, except in the obligations of governments or governmental agencies or units; but where appropriate they fit into the rule here stated.

Following the basic principles of the Negotiable Instruments Law the cases have generally held that an issuer is estopped from denying representations made in the text of a security. *Delaware-New Jersey Ferry Co. v. Leeds*, 21 Del. Ch. 279, 186 A. 913 (1936). Nor is a defect in form or the invalidity of a security normally available to the issuer as a defense. *Bonini v. Family Theatre Corporation*, 327 Pa. 273, 194 A. 498 (1937); *First National Bank of Fairbanks v. Alaska Airmotive*, 119 F.2d 267 (C.C.A.Alaska 1941).

This general rule of estoppel is here adopted in favor of purchasers, with the exception noted above.

3. The last sentence of subsection (1) (A.C.A. § 4-8-202(1)) and all of subsection (2) (A.C.A. § 4-8-202(2)) embody the concept that it is the duty of the issuer, not of the purchaser, to make sure that the security complies with the law governing its issue. The last sentence of subsection (1) (A.C.A. § 4-8-202(1)) makes clear that the issuer cannot, by incorporating a reference to a statute or other document, charge the purchaser with notice of the security's invalidity. Subsection (2) (A.C.A. § 4-8-202(2)) gives to a purchaser

for value without notice of the defect the right to enforce the security against the issuer despite the presence of a defect that otherwise would render the security invalid. This right accrues to a purchaser regardless of whether the security has been transferred to him through physical delivery of a certificate (Section 8-313(1)(a) (A.C.A. § 4-8-313(1)(a))), through registration of transfer or pledge of an uncertificated security (Section 8-313(1)(b) (A.C.A. § 4-8-313 (1)(b))), or through some other method in which he receives no certificate or initial transaction statement. (Section 8-313(1)(c)-(j) (A.C.A. § 4-8-313(1)(c)-(j))). There are three circumstances in which a purchaser does not gain such rights: first, if the defect involves a violation of constitutional provisions, these rights accrue only to a subsequent purchaser (Section 8-102(2) (A.C.A. § 4-8-102(2))). This Article (Chapter) leaves to the law of each particular state the rights of a purchaser on original issue of a security with a constitutional defect. No negative implication is intended by the explicit grant of rights to a subsequent purchaser.

Second, governmental issuers are distinguished in subsection (2) (A.C.A. § 4-8-202(2)) from other issuers as a matter of public policy, and additional safeguards are imposed before governmental issues are validated. Governmental issuers are estopped from asserting defenses only if there has been substantial compliance with the legal requirements governing the issue or if substantial consideration has been received and a stated purpose of the issue is one for which the issuer has power to borrow money or issue the security. The purpose of the substantial compliance requirement is to make certain that a mere technicality as, e.g., in the manner of publishing election notices, shall not be a ground for depriving an innocent purchaser of his rights in the security. The policy is here adopted of such cases as *Tommie v. City of Gadsden*, 229 Ala. 521, 158 So. 763 (1935), in which minor discrepancies in the form of the election ballot used were overlooked and the bonds were declared valid since there had been substantial compliance with the statute.

A long and well established line of Federal cases recognizes the principle of estoppel in favor of bona fide purchasers where municipalities issue bonds contain-



ing recitals of compliance with governing constitutional and statutory provisions, made by the municipal authorities entrusted with determining such compliance. *Chaffee County v. Potter*, 142 U.S. 355, 12 S.Ct. 216, 35 L.Ed. 1040 (1892); *Oregon v. Jennings*, 119 U.S. 74, 7 S.Ct. 124, 30 L.Ed. 323 (1886); *Gunnison County Commissioners v. Rollins*, 173 U.S. 255, 19 S.Ct. 390, 43 L.Ed. 689 (1898). This rule has been qualified, however, by requiring that the municipality have power to issue the security. *Anthony v. County of Jasper*, 101 U.S. 693, 25 L.Ed. 1005 (1879); *Town of South Ottawa v. Perkins*, 94 U.S. 260, 24 L.Ed. 154 (1876). This section follows the case law trend, simplifying the rule by setting up two conditions for an estoppel against a governmental issuer: (1) substantial consideration given, and (2) power in the issuer to borrow money or issue the security for the stated purpose. As a practical matter the problem of policing governmental issuers has been alleviated by the present practice of requiring legal opinions as to the validity of the issue. The bulk of the case law on this point is more than 50 years old and it may be assumed that the question now seldom arises.

Section 8-104 (A.C.A. § 4-8-104) regarding over-issue, provides the third exception to the rule that an innocent purchase for value takes a valid security despite the presence of a defect that would otherwise give rise to invalidity. See that section and its comment for further explanation.

4. Subsection (3) (A.C.A. § 4-8-202(3)) is in effect a definitional provision. The person purported to have issued a certificated security is not an "issuer", and the certificate is not a "certificated security", unless that person actually took the actions that constituted issue. See Sections 8-102(1)(a) (A.C.A. § 4-8-102(1)(a)) and 8-201(1) (A.C.A. § 4-8-201(1)). Similarly, a statement purportedly sent by an issuer is not an "initial transaction statement" if it was not actually sent by the issuer. (Section 8-408(4), (1), (2) and (3) (A.C.A. § 4-8-408(4), (1), (2) and (3))). Section 8-205 (A.C.A. § 4-8-205) is a caveat to both of these general rules.

5. Subsection (4) (A.C.A. § 4-8-202(4)) gives the general rule that defenses of the issuer are ineffective against a purchaser for value without notice of the defense.

Notice to the purchaser may come from sources other than a notation on a certificate or an initial transaction statement. Compare Section 8-103 (A.C.A. § 4-8-103) with respect to an issuer's lien.

6. Subsection (5) (A.C.A. § 4-8-202(5)) is included to make clear that this section does not affect the presently recognized right of either party to a "when, as and if" or "when distributed" contract to cancel the contract on substantial change.

#### *Cross References:*

Point 1: Section 8-313 (A.C.A. § 4-8-313).

Point 2: Sections 1-201 (A.C.A. § 4-1-201), 8-103 (A.C.A. § 4-8-103), 8-203 (A.C.A. § 4-8-203), 8-204 (A.C.A. § 4-8-204).

Point 3: Sections 1-201 (A.C.A. § 4-1-201), 8-102 (A.C.A. § 4-8-102) and 8-104 (A.C.A. § 4-8-104).

Point 4: Sections 8-102 (A.C.A. § 4-8-102), 8-201 (A.C.A. § 4-8-201) and 8-205 (A.C.A. § 4-8-205).

Point 5: Section 8-103 (A.C.A. § 4-8-103).

See Sections 8-104 (A.C.A. § 4-8-104), 8-203 (A.C.A. § 4-8-203), 8-205 (A.C.A. § 4-8-205) and 8-206 (A.C.A. § 4-8-206).

#### *Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Genuine". Section 1-201 (A.C.A. § 4-1-201).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Subsequent Purchaser". Section 8-102 (A.C.A. § 4-8-102).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Unauthorized Signature". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

No. 514, § 3(8-202), to incorporate the 1977 changes to this Uniform Commercial Code section.

\*This section was amended by Acts 1985,

### **Comment to § 8-203 (A.C.A. § 4-8-203)\***

#### *Prior Uniform Statutory Provision:*

Sections 52(2), 53, Uniform Negotiable Instruments Law.

#### *Purposes of Changes:*

1. The problem of matured or called securities is here dealt with in terms of the effect of such events in giving notice of the issuer's defenses and not in terms of "negotiability". The substance of this section applies only to certificated securities because such securities may be transferred to a purchaser by delivery after they have matured, been called or become redeemable or exchangeable. It is contemplated that uncertificated securities which have matured or been called will merely be cancelled on the books of the issuer and the proceeds sent to the registered owner or registered pledgee, as the case may be. Uncertificated securities which become redeemable or exchangeable, at the option of the owner, may be transferred to a purchaser, but the transfer is effectuated only by registration of transfer, thus necessitating communication with the issuer. If defects or defenses in such securities exist, the issuer will necessarily have the opportunity to bring them to the attention of the purchaser in the initial transaction statement sent to him.

2. The fact that a certificated security is in circulation long after it has been called for redemption or exchange must give rise to the question in a purchaser's mind as to why it has not been surrendered. After the lapse of a reasonable period of time he can no longer claim that he had "no reason to know" of any defects or irregularities in its issue. Where funds are available for the redemption of the security it is normally turned in more promptly and a shorter time is set as the "reasonable period", subsection (1)(a) (A.C.A. § 4-8-203(1)(a)), than is set where funds are not available.

It is true that defaulted certificated securities are frequently traded on financial

markets in the same manner as unmatured and defaulted instruments and a purchaser might not be placed upon notice of irregularity by the mere fact of default. An issuer, however, should at some point be placed in a position to determine definitely its liability on an invalid or improper issue, and for this purpose a security under this section becomes "stale" two years after the default. But notice that a different rule applies when the question is notice not of issuer's defenses but of claims of ownership. Section 8-305 (A.C.A. § 4-8-305) and comment.

3. Nothing in this section is designed to extend the life of preferred stocks called for redemption as "shares of stock" beyond the redemption date. After such a call, the security represents only a right to the funds set aside for redemption.

#### *Cross References:*

See Sections 8-104 (A.C.A. § 4-8-104), 8-202 (A.C.A. § 4-8-202) and 8-305 (A.C.A. § 4-8-305).

#### *Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

\*This section was amended by Acts 1985, No. 514, § 3(8-203), to incorporate the 1977 changes to this Uniform Commercial Code section.



**Comment to § 8-204 (A.C.A. § 4-8-204)\****Prior Uniform Statutory Provision:*

Section 15, Uniform Stock Transfer Act.

*Purposes:*

1. Use of the words "noted" and "notation" is intended to make clear that the restriction need not be set forth in full text. See *Allen v. Biltmore Tissue Corporation*, 2 N.Y.2d 534, 141 N.E.2d 812 (1957).

2. Securities traded on financial markets are generally assumed to be free of adverse claims (Section 8-302 (A.C.A. § 4-8-302)). That assumption should not be lightly negated. Therefore, a strict rule as to notice of a restriction on transfer is here imposed. The issuer can protect itself by noting the restriction on the certificate or initial transaction statement. Refusal by an issuer to register a transfer on the basis of an unnoted restriction constitutes a conversion and the issuer can be compelled to register the transfer under the policy of Part 4 of this Article (Chapter). *Hulse v. Consolidated Quicksilver Mining Corporation*, 65 Idaho 768, 154 P.2d 149 (1944); *Mancini v. Patrizi*, 110 Cal.App. 42, 293 P. 828 (1930). Conversely, the issuer to whom a certificated security with proper notation of a restriction is presented thereby receives timely notification of an adverse claim and is under a duty to inquire (Section 8-403 (A.C.A. § 4-8-403)).

A purchaser with actual knowledge of an unnoted restriction certainly has notice of an adverse claim (Section 8-304 (A.C.A. § 4-8-304) and Comment). In that situation this section adopts the reasoning of *Baumohl v. Goldstein*, 95 N.J.Eq. 597, 124 A. 118 (1924), and *Tomoser v. Kamphausen*, 307 N.Y. 797, 121 N.E.2d 622 (1954), rejecting the contrary holding of such cases as *Costello v. Farrell*, 234 Minn. 453, 48 N.W.2d 557 (1951).

3. A transferee who purchases securities in organized financial markets often may neither take physical delivery of a certificated security nor have an uncertificated security registered in his name. See Section 8-313(1)(c) through (j) (A.C.A. § 4-8-313(c) through (j)). Under those circumstances the transferee may have no occasion to examine the writing on the certificate or the initial transaction statement. Nonetheless the transferee is

charged with notice of restrictions noted on the certificate or on the initial transaction statement sent to the registered owner or the registered pledgee. See Section 8-202(1) (A.C.A. § 4-8-202(1)) and Comment 1 thereto.

4. Most jurisdictions recognize the right of issuers to impose restrictions giving either the issuer itself or other stockholders the option to purchase the security at an ascertained price before it is offered to third parties. *Vannucci v. Peduni*, 217 Cal. 138, 17 P.2d 706 (1932); *People ex rel. Rudaitis v. Galskis*, 233 Ill.App. 414 (1924); *Bloomingtondale v. Bloomingtondale*, 107 Misc. 646, 177 N.Y.S. 873 (1919). This is the type of restriction contemplated by the present section. Mere notation on the certificate or initial transaction statement cannot, of course, validate an otherwise unlawful restriction. The present section in no way alters the prevailing case law which recognizes free alienability as an inherent attribute of securities and holds invalid unreasonable restraints on alienation such as those requiring consents of directors without establishing criteria for the granting or withholding of such consents and those giving the directors an option of purchase at a price to be fixed in their sole discretion. *Howe v. Roberts*, 209 Ala. 80, 95 So. 344 (1923); *People ex rel. Malcolm v. Lake Sand Corporation*, 251 Ill.App. 499 (1929); *Morris v. Hussong Dyeing Machine Co.*, 81 N.J.Eq. 256, 86 A. 1026 (1913); *New England Trust Co. v. Abbott*, 162 Mass. 148, 38 N.E. 432, 27 L.R.A. 271 (1894).

No interference is intended with the common practice of closing books for proper corporate purposes.

5. Cooperative associations and ventures, as well as private clubs are generally considered an exception to the rules against restrictions on transfer as unreasonable restraints on alienation and are permitted for example to require the consents of governing bodies such as a board of directors. *Penthouse Properties, Inc. v. 1158 Fifth Avenue, Inc.*, 256 App.Div. 685, 11 N.Y.S.2d 417 (1939).

Historically restrictions on transfer were most commonly imposed by so-called "closely-held" issuers (including cooperatives and the like) in an attempt to restrict

control if not total membership to a homogenous security holder group. They have been increasingly resorted to by issuers with publicly held securities seeking to police enforcement to the registration requirement of the Securities Act of 1933 against persons purchasing their securities in a transaction exempt from those requirements (e.g., one "not involving any public offering" [Securities Act of 1933, Section 4(2)] or against persons in a "control" relationship to the issuer. [See Securities Act of 1933, Section 2(11) and Rule 405 of the Rules and Regulations of the Securities and Exchange Commission under that Act.] Particularly in the latter context in which notation of the restriction on all affected certificates or initial transaction statements may not be practical, the issuer enforces it by notifying the holders of such certificates and refusing requests to register transfer out of the name of the "controlling person" either for purposes of sale or for delivery after sale, relying on the stated exception as to a person "with actual knowledge" of the restriction.

6. This section deals only with restrictions imposed by the issuer and restrictions imposed by statute are not affected. See *Quiner v. Marblehead Social Co.*, 10 Mass. 476 (1813); *Madison Bank v. Price*, 79 Kan. 289, 100 P. 280 (1909); *Healey v. Steele Center Creamery Ass'n*, 115 Minn. 451, 133 N.W. 69 (1911). Nor does it deal with private agreements between stock-

holders containing restrictive covenants as to the sale of the security as in *In re Consolidated Factors Corporation*, 46 F.2d 561 (S.D.N.Y.1931).

7. An analogous provision concerning issuer's liens appears at Section 8-103 (A.C.A. § 4-8-103).

#### *Cross References:*

Point 7: Section 8-103 (A.C.A. § 4-8-103).

See Part 4 of this Article (Chapter).

#### *Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Conspicuous". Section 1-201 (A.C.A. § 4-1-201).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-204), to incorporate the 1977 changes to this Uniform Commercial Code section.

#### **Comment to § 8-205 (A.C.A. § 4-8-205)\***

##### *Prior Uniform Statutory Provision:*

Section 23, Uniform Negotiable Instruments Law.

##### *Purposes:*

1. In current practice the problem of forged or unauthorized signatures arises most frequently where an employee of the issuer, transfer agent or registrar has access to securities which he is required to prepare for issue by affixing the corporate seal or by adding a signature necessary for issue. This section is based upon the issuer's duty to avoid the negligent entrusting of securities to such persons. Issuers have long been held responsible for signatures placed upon securities by parties whom they have held out to the public as authorized to prepare such securities.

See *Fifth Avenue Bank of New York v. The Forty-Second Street & Grand Street Ferry Railroad Co.*, 137 N.Y. 231, 33 N.E. 378, 19 L.R.A. 331, 33 Am.St.Rep. 712 (1893); *Jarvis v. Manhattan Beach Co.*, 148 N.Y. 652, 43 N.E. 68, 31 L.R.A. 776, 51 Am.St.Rep. 727 (1896). The "apparent authority" concept of some of the caselaw, however, is here extended and this section expressly rejects the technical distinction, made by the courts reluctant to recognize forged signatures, between cases where the forger signs a signature he is authorized to sign under proper circumstances and those in which he signs a signature he is never authorized to sign. *Citizens' & Southern National Bank v. Trust Co. of Georgia*, 50 Ga.App. 681, 179 S.E. 278 (1935). Normally the purchaser is not in a



position to determine which signature a forger, entrusted with the preparation of securities, has "apparent authority" to sign and which he has not. The issuer, on the other hand, can protect itself against such fraud by the careful selection and bonding of agents and employees, or by action over against transfer agents and registrars who in turn may bond their personnel.

2. It is contemplated that purchasers of uncertificated securities will rely on initial transaction statements (ITS's) sent to them, much as purchasers of certificated securities rely on certificates. The issuer's signature is thus required to ensure genuineness of the ITS. Section 8-408(4) (A.C.A. § 4-8-408(4)). In this regard the principle difference between the certificates and ITS's is that only the one to whom the ITS is sent can safely rely on it, whereas a certificated security is a negotiable instrument and may be relied upon by transferees other than the original purchaser. The issuer's responsibility for unauthorized signatures otherwise is the same in both instances.

A transferee of an uncertificated security may be protected indirectly by this section despite the fact that he has not received the ITS. If his transferor received an ITS and was protected by this section, Section 8-301(1) (A.C.A. § 4-8-301(1)) gives those rights to the transferee.

3. The issuer cannot be held liable for the honesty of employees not entrusted, directly or indirectly, with the signing, preparation, or responsible handling of similar securities or similar ITS's and whose possible commission of forgery it has no reason to anticipate. The result in such cases as *Hudson Trust Co. v. American Linseed Co.*, 232 N.Y. 350, 134 N.E. 178 (1922), and *Dollar Savings Fund & Trust Co. v. Pittsburgh Plate Glass Co.*, 213 Pa. 307, 62 A. 916, 5 Ann. Cas. 248 (1906) is here adopted.

4. This section is not concerned with forged or unauthorized indorsements (Section 8-311 (A.C.A. § 4-8-311)), but only with unauthorized signatures of issuers, transfer agents, etc., placed upon certificated securities or initial transaction statements during the course of their issue. The protection here stated is available to all purchasers for value without notice and not merely to subsequent purchasers.

#### *Cross References:*

Point 4: Section 8-311 (A.C.A. § 4-8-311).

See Section 8-202(3) (A.C.A. § 4-8-202(3)).

#### *Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Sign". Section 1-201 (A.C.A. § 4-1-201).

"Unauthorized Signature". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-205), to incorporate the 1977 changes to this Uniform Commercial Code section.

#### **Comment to § 8-206 (A.C.A. § 4-8-206)\***

##### *Prior Uniform Statutory Provision:*

Sections 14, 15 and 124, Uniform Negotiable Instruments Law; Section 16, Uniform Stock Transfer Act.

##### *Purposes:*

1. The problem of forged or unautho-

rized signatures necessary for the issue or transfer of a security or for the authentication of an initial transaction statement is not involved here, and a person in possession of a blank certificate or of a writing that would be an initial transaction statement if it were properly signed is

not, by this section, given authority to fill in blanks with such signatures.

2. Completion of blanks left in a transfer instruction is dealt with elsewhere (Section 8-308(5) (A.C.A. § 4-8-308(5))). Blanks left upon authentication of an initial transaction statement or upon issue of a certificated security are the only ones dealt with here, and a purchaser for value without notice is protected. A purchaser is not in a good position to determine whether blanks were completed by the issuer or by some person not authorized to complete them. On the other hand the issuer can protect itself by not placing its signature on the writing until the blanks are completed or, if it does sign before all blanks are completed, by carefully selecting the agents and employees to whom it entrusts the writing after authentication. With respect to a certificated security or an initial transaction statement that is completed by the issuer but later is altered, the issuer has done everything it can to protect the purchaser and thus is not charged with the terms as altered. However, it is charged according to the original terms, since it is not thereby prejudiced.

If the completion or alteration is obviously irregular, the purchaser may be charged with notice. See Section 1-201(25) (A.C.A. § 4-1-201(25)).

3. Only the purchaser who physically takes the certificate or receives the initial transaction statement is directly protected. However, a transferee may receive protection indirectly through Section 8-301(1) (A.C.A. § 4-8-301(1)).

4. The protection granted a purchaser for value without notice under this section

is modified to the extent that an overissue may result where an incorrect amount is inserted into a blank (Section 8-104 (A.C.A. § 4-8-104)).

#### *Cross References:*

Point 2: Sections 1-201 (A.C.A. § 4-1-201), 8-302 (A.C.A. § 4-8-302) and 8-308 (A.C.A. § 4-8-308).

Point 3: Section 8-301 (A.C.A. § 4-8-301).

Point 4: Section 8-104 (A.C.A. § 4-8-104).

See Sections 8-205 (A.C.A. § 4-8-205) and 8-311 (A.C.A. § 4-8-311).

#### *Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-206), to incorporate the 1977 changes to this Uniform Commercial Code section.

### **Comment to § 8-207 (A.C.A. § 4-8-207)\***

#### *Prior Uniform Statutory Provision:*

Section 3, Uniform Stock Transfer Act.

#### *Purposes:*

1. Subsection (1) (A.C.A. § 4-8-207(1)) states the issuer's right to treat the registered owner of a certificated security as the person entitled to exercise all the rights of an owner. This right of the issuer is limited by the provisions of Part 4 of this article (chapter) — once there has been due presentation for registration of transfer, the issuer has a duty to register ownership in the name of the transferee.

Section 8-401 (A.C.A. § 4-8-401). Thus its right to treat the old registered owner as exclusively entitled to the rights of ownership must cease.

The issuer may, under this section (A.C.A. § 4-8-207), make distributions of money or securities to the registered owners of certificated securities without requiring further proof of ownership, provided that such distributions are distributable to the owners of all securities of the same issue and the terms of the security do not require its surrender as a condition of payment or exchange. Any



such distribution shall constitute a defense against a claim for the same distribution by a person, even if that person is in possession of the security and is a bona fide purchaser of the security. See PEB Commentary No. 4, dated March 10, 1990.

Subsection (2) (A.C.A. § 4-8-207(2)) states a parallel rule for uncertificated securities, with the important exception that the rights of the registered owner are curtailed when the uncertificated security is subject to a registered pledge. See Section 8-108 (A.C.A. § 4-8-108). Thus, subsection (3) (A.C.A. § 4-8-207(3)) denies the registered owner the power to order transfer of an uncertificated security subject to a registered pledge until the pledge has been released by order of the pledgee. See Section 8-308(4) and (7)(b) (A.C.A. § 4-8-308(4) and (7)(b)).

Subsection (4) (A.C.A. § 4-8-207(4)) establishes the right of the registered pledgee to control the transfer of an uncertificated security subject to his pledge. The three paragraphs of subsection (4) (A.C.A. § 4-8-207(4)) illustrate the mechanics for three common transactions: (a) the outright transfer of the security, free of the pledge; (b) the transfer of registered ownership, subject to the pledge; and (c) the transfer of the pledgee's interest without disturbing the registered ownership. These transactions are not intended to be exclusive. For example, the transfer of a pledged uncertificated security to a new owner subject to the interest of a new pledgee might be accomplished in several ways. There could be a release of his interest by the old pledgee followed by a transfer of registered ownership from the old owner to the new owner and a pledge from the new owner to the new pledgee. Or, if the respective pledgees wished to maintain complete control over the security, the old pledgee could order a transfer of his interest to the new pledgee under paragraph (c) (A.C.A. § 4-7-207(4)(c)) and the new pledgee could then order the transfer of registered ownership from the old owner to the new owner under paragraph (b) (A.C.A. § 4-8-207(4)(b)). Still other combinations are possible, depending on the positions of the parties.

Subsection (6) (A.C.A. § 4-8-207(6)) insures that stock dividends or splits issued with respect to a pledged uncertificated security and securities or money distrib-

uted or paid in exchange for a pledged uncertificated security will remain within the control of the registered pledgee. This result cannot be extended to pledges of certificated securities because the issuer will normally be unaware of the pledgee's rights unless the pledgee has caused a transfer to be registered.

2. The rule of such cases as *Turnbull v. Longacre Bank*, 249 N.Y. 159, 163 N.E. 135 (1928), which held the issuer liable for paying out dividends to the record holder after the transferee had given notice of the transfer and demanded that a new certificate be issued to him, is left unchanged. However, such cases as *Morrison v. Gulf Oil Corporation*, 189 Miss. 212, 196 So. 247 (1940), holding that Section 3 of the Uniform Stock Transfer Act did not change the common law as to the issuer's liability for dealing with the record holder after mere notice of a pledge, are expressly rejected. Mere notice is not enough under this section to impose upon the issuer the duty of dealing with the pledgee although it may constitute notice to the issuer of a claim of ownership under Part 4.

Subsections (1) and (2) (A.C.A. § 4-8-207(1) and (2)) are permissive and do not require that the issuer deal exclusively with the registered owner. It is free to require proof of ownership before paying out dividends or the like if it chooses to. *Barbato v. Breeze Corporation*, 128 N.J.L. 309, 26 A.2d 53 (1942).

3. This section does not operate to determine who is finally entitled to exercise voting and other rights or to receive payments and distributions. The parties are still free to incorporate their own arrangements as to these matters in seller-purchaser agreements which will be definitive as between them.

4. No change in existing state laws as to the liability of registered owners for calls and assessments is here intended; nor is anything in this section designed to estop a record holder from denying ownership when assessments are levied if he is otherwise entitled to do so under state law. See *State ex rel. Squire v. Murfey, Blosson & Co.*, 131 Ohio St. 289, 2 N.E.2d 866 (1936); *Willing v. Delaplaine*, 23 F.Supp. 579 (1937).

5. No interference is intended with the common practice of closing the transfer books or taking a record date for dividend,

voting and other purposes, as provided for in by-laws, charters and statutes.

*Cross References:*

Section 8-108 (A.C.A. § 4-8-108) and Part 4 of this Article (Chapter).

*Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Registered Form". Section 8-102 (A.C.A. § 4-8-102).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Security Interest". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-207), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-208 (A.C.A. § 4-8-208)\***

*Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. The warranties here stated express the current understanding and prevailing case law as to the effect of the signatures of authenticating trustees, transfer agents, and registrars. See *Jarvis v. Manhattan Beach Co.*, 148 N.Y. 652, 43 N.E. 68, 31 L.R.A. 776, 51 Am.St.Rep. 727 (1896). Although it has generally been regarded as the particular obligation of the transfer agent to determine whether securities are in proper forms as provided by the by-laws and Articles of Incorporation, neither a registrar nor an authenticating trustee should properly place a signature upon a certificate or transaction statement without determining whether it is at least regular on its face. The obligations of these parties in this respect have therefore been made explicit in terms of due care. See *Feldmeier v. Mortgage Securities, Inc.*, 34 Cal.App.2d 201, 93 P.2d 593 (1939).

2. Those cases which hold that an authenticating trustee is not liable for any defect in the mortgage or property which secures the bond or for any fraudulent misrepresentations made by the issuer are not here affected since these matters do not involve the genuineness or proper form of the security. *Ainsa v. Mercantile Trust Co.*, 174 Cal. 504, 163 P. 898 (1917); *Tschetinian v. City Trust Co.*, 186 N.Y.

432, 79 N.E. 401 (1906); *Davidge v. Guardian Trust Co. of New York*, 203 N.Y. 331, 96 N.E. 751 (1911).

3. The charter or applicable statute may affect the capacity of a bank or other corporation undertaking to act as an authenticating trustee, registrar or transfer agent. See, for example, the Federal Reserve Act (U.S.C.A., Title 12, Banks and Banking, Section 248) under which the Board of Governors of the Federal Reserve Bank is authorized to grant special permits to National Banks permitting them to act as trustees. Such corporations are therefore held to certify as to their legal capacity to act as well as to their authority.

4. Authenticating trustees, registrars and transfer agents have normally been held liable for an issue in excess of the authorized amount. *Jarvis v. Manhattan Beach Co.*, *supra*; *Mullen v. Eastern Trust & Banking Co.*, 108 Me. 498, 81 A. 948 (1911). In imposing upon these parties a duty of due care with respect to the amount they are authorized to help issue, this section does not necessarily validate the security, but merely holds persons responsible for the excess issue liable in damages for any loss suffered by the purchaser.

5. Aside from questions of genuineness and excess issued these parties are not held to certify as to the validity of the security unless they specifically under-



take to do so. The case law which has recognized a unique responsibility on the transfer agent's part to testify as to the validity of any security which it countersigns is rejected.

6. This provision does not prevent a transfer agent or issuer from agreeing with a registrar of stock to protect the registrar in respect of the genuineness and proper form of a certificated security or initial transaction statement signed by the issuer or the transfer agent or both. Nor does it interfere with proper indemnity arrangements between the issuer and trustees, transfer agents, registrars and the like.

7. An unauthorized signature is a signature for purposes of this section if and only if it is made effective by Section 8-205 (A.C.A. § 4-8-205).

*Cross References:*

Sections 8-102 (A.C.A. § 4-8-102), 8-205 (A.C.A. § 4-8-205) and 8-406 (A.C.A. § 4-8-406).

*Definitional Cross References:*

"Agreed". Section 1-201 (A.C.A. § 4-1-201).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Genuine". Section 1-201 (A.C.A. § 4-1-201).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 27, to adopt the 1962 changes to this Uniform Commercial Code section, and by Acts 1985, No. 514, § 3(8-208), to incorporate the 1977 changes to this Uniform Commercial Code section.

### **Comment to § 8-301 (A.C.A. § 4-8-301)\***

*Prior Uniform Statutory Provision:*

Section 58, Uniform Negotiable Instruments Law.

*Purposes:*

1. The concept of transfer is defined only by example (Section 8-313 (A.C.A. § 4-8-313)), but it clearly involves the passing of rights in the security from one party to another. Subsection (1) (A.C.A. § 4-8-301(1)) states the "shelter" provision of the Negotiable Instruments Law — upon transfer of the security a purchaser acquires the rights his transferor had. There are at least three exceptions to this basic rule, two of which limit the purchaser's rights and one of which expands them. First, subsection (1) (A.C.A. § 4-8-301(1)) explicitly makes its rule subject to Section 8-302(4) (A.C.A. § 4-8-302(4)), which prevents certain transferees from being freed of the taint of earlier fraud or notice. The second exception, stated in subsection (2) (A.C.A. § 4-8-301(2)), is that there may be a transfer explicitly limited to an interest less than the transferor's entire interest. Finally Section

8-302 (A.C.A. § 4-8-302) provides that a bona fide purchaser takes certain rights of his own account, regardless of the rights his transferor had.

2. Transfers by operation of law are not intended to be covered by this Article (Chapter). For example, transfers from decedent to administrator, from ward to guardian, and from bankrupt to trustee in bankruptcy are governed by other law as to both the time they occur and the substance of the transfer. Subsequent delivery and registration on the issuer's record merely confirm what has already happened.

*Cross References:*

Sections 3-201 (A.C.A. § 4-3-201) and 8-321 (A.C.A. § 4-8-321).

*Definitional Cross References:*

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

No. 514, § 3(8-301), to incorporate the 1977 changes to this Uniform Commercial Code section.

\*This section was amended by Acts 1985,

**Comment to § 8-302 (A.C.A. § 4-8-302)\***

*Prior Uniform Statutory Provision:*

Sections 52, 57, 58 and 59, Uniform Negotiable Instruments Law; Section 7, Uniform Stock Transfer Act.

*Purposes:*

1. Any purchaser for value of a security without notice of a particular defect may take free of the issuer's defense based on that defect, but only a purchaser taking by a formally perfect transfer, for value and without notice of any adverse claim, may take free of adverse claims. The "bona fide purchaser" here dealt with is the person taking free of adverse claims. His rights against the issuer are determined by Part 2 of this Article (Chapter) and his rights to registration are determined by Part 4.

2. Not every form of transfer can confer upon the purchaser the status of bona fide purchaser. In particular, transfers effected through the acknowledgment of a bailee who is not a financial intermediary or through the acknowledgment of a financial intermediary who holds for the transferee a proportionate interest in a fungible bulk do not confer bona fide purchaser status. However, the transferee can acquire all the rights of a bona fide purchaser through the "shelter" provisions of Section 8-301(1) (A.C.A. § 4-8-301(1)) if the transferor had those rights.

3. Protection is extended to bona fide purchasers of all investment securities, whether such securities were considered negotiable or non-negotiable under the prior law. This is the result sought by many cases which have resolved doubts in favor of negotiability despite terms in bonds which militated against their negotiability under the provisions of the Negotiable Instruments Law. See *Paxton v. Miller*, 102 Ind.App. 511, 200 N.E. 87 (1936); *Scott v. Platt*, 171 Or. 379, 135 P.2d 769 (1943). Such cases as *U.S. Gypsum v. Faroll*, 296 Ill.App. 47, 15 N.E.2d 888 (1938), protecting bona fide purchasers of stock certificates under the provisions of the Stock Transfer Act are adopted and approved.

4. An adverse claim may be either legal or equitable, e.g., that the claimant is the beneficial owner of a security, though not the legal owner of it, or that it has been or is proposed to be transferred in breach of trust or a valid restriction on transfer (See Section 8-204 (A.C.A. § 4-8-204) and Comment). Note that there may be claims of ownership that are not "adverse" — e.g., the claim of a principal against his agent including that of a customer against his broker (Section 8-303 (A.C.A. § 4-8-303)). The agent's knowledge of his principal's claim thus cannot defeat the agent's right to be a bona fide purchaser under this section.

5. Subsection (4) (A.C.A. § 4-8-302(4)) provides an exception to the "shelter" provisions of Section 8-301(1) (A.C.A. § 4-8-301(1)), but applies only to a transferee of a certificated security who as a prior holder of the particular security had notice of adverse claims or who has been a party to fraud or illegality affecting the particular security.

*Cross References:*

Sections 3-302 (A.C.A. § 4-3-302) and 8-301 (A.C.A. § 4-8-301).

Point 4: Section 8-204 (A.C.A. § 4-8-204) and its comment.

*Definitional Cross References:*

"Bearer Form". Section 8-102 (A.C.A. § 4-8-102).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Good Faith". Section 1-201 (A.C.A. § 4-1-201).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Indorsed". Section 8-308 (A.C.A. § 4-8-308).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).



"Registered Form". Section 8-102 (A.C.A. § 4-8-102).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

### **Comment to § 8-303 (A.C.A. § 4-8-303)\***

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

This section defines "broker" for purposes of this Article (Chapter) in terms of function in this particular transaction. The term is applicable to the person performing the function. The differentiation under the Securities Exchange Act of 1934 between "broker" and "dealer" is of no significance under this Article (Chapter). This and similar distinctions are preserved for other purposes by the last sentence of the section.

#### *Definitional Cross References:*

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-303), to incorporate the 1977 changes to this Uniform Commercial Code section.

### **Comment to § 8-304 (A.C.A. § 4-8-304)\***

#### *Prior Uniform Statutory Provision:*

Sections 37, 56, Uniform Negotiable Instruments Law.

#### *Purposes:*

1. Section 8-302 (A.C.A. § 4-8-302) defines "bona fide purchaser" in terms of three distinct elements, "value", "good faith", and lack of "notice of any adverse claim". This section deals only with notice and presents specific situations in which a purchaser is charged with notice of adverse claims as a matter of law. The listing is not exhaustive and does not exclude other situations in which the trier of the facts may determine that similar notice has been given. For example, receipt of notification that the particular security has been lost or stolen raises the question of notice "forgotten" in good faith. *Kentucky Rock Asphalt v. Mazza's Admr.*, 264 Ky. 158, 94 S.W.2d 316 (1936); *Graham v. White-Phillips Co.*, 296 U.S. 27, 56 S.Ct. 21, 80 L.Ed. 20, 102 A.L.R. 24 (1935) but cf., *First National Bank of Odessa v. Fazzari*, 10 N.Y.2d 394, 179 N.E.2d 493 (1961). Also suspicious characteristics of the transaction may give a purchaser (particularly a commercially sophisticated

purchaser such as a broker) "reason to know." *U.S. Fidelity & Guaranty Co. v. Goetz*, 285 N.Y. 74, 32 N.E.2d 798 (1941); *Morris v. Muir*, 111 Misc. 739, 180 N.Y.S. 913 (1920).

2. Subsection (1)(a) (A.C.A. § 4-8-304(1)(a)) refers to situations in which a certificated security endorsed "for collection" or "for surrender" is being offered for transfer and follows in effect Section 37 of the Negotiable Instruments Law, which provides that subsequent indorsees acquire only the title of the first indorsee under a restrictive indorsement.

3. A purchaser of an uncertificated security is charged with notice of adverse claims noted in the initial transaction statement. If the security is transferred to him other than by registration on the issuer's records, he is charged with notice of claims noted in the statement sent to the registered owner (or to the registered pledgee if his rights were transferred by notice to or acknowledgment from a registered pledgee).

Situations may arise in which the issuer receives notice of an adverse claim after registration of transfer, pledge or release but before the initial transaction state-

ment is prepared and sent. The issuer ought not to note those claims on the statement. See Section 8-408(1)(d), (2)(d) and (3)(d) (A.C.A. § 4-8-408(1)(d), (2)(d) and (3)(d)). If the issuer should mistakenly note such a claim, subsection (2) (A.C.A. § 4-8-304(2)) does not charge the purchaser with notice.

4. In subsection (3) (A.C.A. § 4-8-304(3)) some situations involving purchase from one described or identifiable as a fiduciary are explicitly provided for, again imposing an objective standard, while leaving the door open to other circumstances which may constitute notice of adverse claims. Mere notice of the existence of the fiduciary relation is not enough in itself to prevent bona fide purchase, and the purchaser is free to take the security on the assumption that the fiduciary is acting properly. The fact that the security may be transferred to the individual account of the fiduciary or that the proceeds of the transaction are paid into that account in cash would not be sufficient to charge the purchaser with notice of potential breach of fiduciary obligation but as in *State Bank of Binghamton v. Bache*, 162 Misc. 128, 293 N.Y.S. 667 (1937) knowledge that the proceeds are being applied to the personal indebtedness of the fiduciary will charge the purchaser with such notice.

5. The notice here involved is to purchasers. A broker acting as such (Section 8-303 (A.C.A. § 4-8-303)) is treated in this section as a purchaser though he may not be a purchaser under the definitions of that term (Section 1-201(33) (A.C.A. § 4-1-201(33))). On the other hand, a bank, stockbroker or other intermediary who, in the particular transaction acts purely in that capacity, is not a purchaser. Cf. subsections (3) and (4) of Section 8-306 (A.C.A. § 4-8-306(3) and (4)) and Comments 3 and 4 to that Section. Subsection (3) (A.C.A. § 4-8-304(3)) follows the policy of Section 4 of the Uniform Fiduciaries Act and of Section 3-304(2) (A.C.A. § 4-3-304(2)) with respect to commercial paper. Compare Section 7(a) of the Uniform Act

for Simplification of Fiduciary Security Transfers.

The fact that the broker is expressly mentioned in this section carries no negative implication in other sections in which merely the word "purchaser" is used.

An issuer is not a purchaser. Its duty of inquiry is set forth in Part 4.

#### *Cross References:*

Point 5: Part 4 of this Article (Chapter).

See Sections 8-104 (A.C.A. § 4-8-104), 8-302 (A.C.A. § 4-8-302), 8-305 (A.C.A. § 4-8-305) and 8-308 (A.C.A. § 4-8-308).

#### *Definitional Cross References:*

"Adverse Claim". Section 8-302 (A.C.A. § 4-8-302).

"Bearer Form". Section 8-102 (A.C.A. § 4-8-102).

"Broker". Section 8-303 (A.C.A. § 4-8-303).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Indorsed". Section 8-308 (A.C.A. § 4-8-308).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Intermediary Bank". Section 4-105 (A.C.A. § 4-4-105).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Registered Form". Section 8-102 (A.C.A. § 4-8-102).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-304), to incorporate the 1977 changes to this Uniform Commercial Code section.



**Comment to § 8-305 (A.C.A. § 4-8-305)\****Prior Uniform Statutory Provision:*

Sections 52(2), 53, Uniform Negotiable Instruments Law.

*Purposes:*

1. The fact of "staleness" is viewed as notice of certain defects after the lapse of stated periods, but the maturity of the security does not operate automatically to affect holders' rights. The periods of time here stated are shorter than those appearing in the provisions of this Article (Chapter) on staleness as notice of defects or defenses (Section 8-203 (A.C.A. § 4-8-203)) since a purchaser who takes a security after funds or other securities are available for its redemption has more reason to suspect claims of ownership than issuer's defenses. An owner will normally turn in his security rather than transfer it at such a time.

Of itself, a default never constitutes notice of a possible adverse claim. To provide otherwise would not tend to drive defaulted securities home and would serve only to disrupt current financial markets where many defaulted securities are actively traded.

2. The owner is provided with a means of protecting himself while his security is being sent in for redemption or exchange. He may endorse it "for collection" or "for surrender," and this constitutes notice of his claims (Section 8-304 (A.C.A. § 4-8-304)). The present section does not come into operation unless the time period here stated has elapsed.

3. Unpaid or overdue coupons attached to a bond do not bring it within the operation of this section, although under some

circumstances they may give the purchaser "reason to know" of claims of ownership. *Georgia Granite R. Co. v. Miller*, 144 Ga. 665, 87 S.E. 897 (1916).

4. This section has been made expressly applicable to certificated securities only, since the transfer of an uncertificated security normally will involve communication with the issuer and a consequent opportunity for the issuer to give the transferee effective notice of adverse claims.

*Cross References:*

Point 1: Section 8-203 (A.C.A. § 4-8-203).

Point 2: Section 8-304 (A.C.A. § 4-8-304).

See Section 8-103 (A.C.A. § 4-8-103).

*Definitional Cross References:*

"Adverse Claim". Section 8-302 (A.C.A. § 4-8-302).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-305), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-306 (A.C.A. § 4-8-306)\****Prior Uniform Statutory Provision:*

Sections 65, 66, 67, 69, Uniform Negotiable Instruments Law; Sections 11, 12, Uniform Stock Transfer Act.

*Purposes:*

1. The warranties with respect to certificated securities have been recognized by the prevailing case law as well as by the prior Acts cited. See *Boston Tow Boat Co. v. Medford Nat. Bank*, 232 Mass. 38, 121 N.E. 491 (1919); *Burtch v. Child*,

*Hulswit & Co.*, 207 Mich. 205, 174 N.W. 170 (1919).

Usual estoppel principles apply with respect to transfers of both certificated and uncertificated securities whenever the purchaser has knowledge of the defect, and these warranties will not be effective in such a case. In addition, under Section 1-102(3) (A.C.A. § 4-1-102(3)) these provisions apply only "unless otherwise agreed" and the parties are free to enter into any express agreement they

desire where both are aware of possible defects.

2. The second sentence of subsection (1) (A.C.A. § 4-8-306(1)) limits the warranties made by a bona fide purchaser whose presentation of a certificated security is defective in some way but who nonetheless is given a reissued certificated security or an initial transaction statement confirming the transfer of an uncertificated security to him. The effect is to deny the issuer a remedy against such a person unless at the time of presentation the person had knowledge of an unauthorized signature in a necessary indorsement. The issuer can protect itself by refusing to make the transfer or, if it registers the transfer before it discovers the defect, by pursuing its remedy against a signature guarantor.

3. Subsections (3) and (4) (A.C.A. § 4-8-306(3) and (4)) are designed to eliminate all substantive warranties in the case of deliveries of certificated securities by intermediaries and pledgees. Such parties deal primarily with the draft or other claim and, having no access to direct knowledge about the security, they cannot be held to warrant its genuineness or validity. Subsection (8) (A.C.A. § 4-8-306(8)) similarly limits the warranties given by a secured party (or its agent) originating an instruction at the behest of the debtor.

4. The so-called "stock-broker" normally functions as a broker (see definition of "broker", Section 8-303 (A.C.A. § 4-8-303)) and on a few occasions another institution such as a bank may function as a broker — e.g. for a standard broker's commission or similar compensation. In those situations the warranties, rights and privileges of the broker are spelled out in subsection (10) (A.C.A. § 4-8-306(10)). Nevertheless either the so-called "stock-broker" or the bank can qualify for the protection given by subsections (3) and (4) (A.C.A. § 4-8-306(3) and (4)) to an "intermediary" where in the particular transaction it does not function as a broker — e.g. when it transfers securities on a customer's instructions, either without charge or for a nominal handling charge.

5. Subsection (5) (A.C.A. § 4-8-306(5)) establishes the rights of the issuer against one who originates an instruction (Section 8-308(4) (A.C.A. § 4-8-308(4))) that is fraudulent or otherwise improper. The is-

suer's loss — which necessitates the remedy — arises only if the issuer registers the requested transfer, pledge or release and is subjected to liability for improper registration. See Section 8-404(3) (A.C.A. § 4-8-404(3)).

6. Subsection (6) (A.C.A. § 4-8-306(6)) sets forth the warranties made by the instruction originator to a person specially guaranteeing his signature. These warranties mirror those made by the special signature guarantor.

7. Subsection (7) (A.C.A. § 4-8-306(7)) sets forth the warranties made to a purchaser for value by one who originates an instruction. These warranties are quite similar to those made by one transferring a certificated security, subsection (2) (A.C.A. § 4-8-306(2)), the principal difference being the absolute warranty of validity. If upon receipt of the instruction the issuer should dispute the validity of the security, it seems proper to place the burden of proving validity upon the transferor. Because the guarantor of an instruction makes an absolute warranty of rightfulness, Section 8-312(6) (A.C.A. § 4-8-312(6)), he is given the benefit of a similar warranty from the originator in subsection (7) (A.C.A. § 4-8-306(7)).

#### *Cross References:*

See Sections 1-102(3) (A.C.A. § 4-1-102(3)), 8-103 (A.C.A. § 4-8-103), 8-301 (A.C.A. § 4-8-301), 8-311 (A.C.A. § 4-8-311) and 8-405 (A.C.A. § 4-8-405).

#### *Definitional Cross References:*

"Adverse Claims". Section 8-302 (A.C.A. § 4-8-302).

"Appropriate Person". Section 8-308 (A.C.A. § 4-8-308).

"Broker". Section 8-308 (A.C.A. § 4-8-308).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Genuine". Section 1-201 (A.C.A. § 4-1-201).

"Good Faith". Section 1-201 (A.C.A. § 4-1-201).

"Indorsement". Section 8-308 (A.C.A. § 4-8-308).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).



"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Secured Party". Section 9-105 (A.C.A. § 4-9-105).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Security Interest". Section 1-201 (A.C.A. § 4-1-201).

"Unauthorized Signature". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 28(8-306), to incorporate the 1962 changes to this Uniform Commercial Code section, and by Acts 1985, No. 514, § 3(8-306), to incorporate the 1977 changes to this Uniform Commercial Code section.

### Comment to § 8-307 (A.C.A. § 4-8-307)\*

#### *Prior Uniform Statutory Provision:*

Section 49, Uniform Negotiable Instruments Law; Section 9, Uniform Stock Transfer Act.

#### *Purposes:*

1. As between the parties the transfer of a certificated security is made complete upon delivery, but the transferee cannot become a bona fide purchaser of the security until indorsement is made. The indorsement does not operate retroactively, and notice may intervene between delivery and indorsement so as to prevent the transferee from becoming a bona fide purchaser. This Article (Chapter) rejects such cases as *Bethea v. Floyd*, 177 S.C. 521, 181 S.E. 721 (1935), certiorari denied, 296 U.S. 622, 56 S.Ct. 143, 80 L.Ed. 442, holding that the indorsement of a note delivered prior to maturity but indorsed thereafter took effect as of the date of delivery to permit the purchaser to become a holder in due course. Although a purchaser taking without a necessary indorsement may be subject to claims of ownership, any issuer's defense of which he had no notice at the time of delivery will be cut off, since the provisions of this Article (Chapter) protect all purchasers for value without notice (Section 8-202 (A.C.A. § 4-8-202)).

2. The transferee's right to compel an indorsement where a certificated security has been delivered with intent to transfer is recognized in the case law and the Article (Chapter) of this Act on Documents

of Title. See *Coats v. Guaranty Bank & Trust Co.*, 170 La. 871, 129 So. 513 (1930), and Section 7-506 of this Act (A.C.A. § 4-7-506).

3. A proper indorsement is one of the requisites of transfer which a purchaser of a certificated security has a right to obtain (Section 8-316 (A.C.A. § 4-8-316)). A purchaser may not only compel an indorsement under that section but may also recover for any reasonable expense incurred by the transferor's failure to respond to the demand for an indorsement.

#### *Cross References:*

Point 1: Section 8-202 (A.C.A. § 4-8-202).

Point 2: Section 7-506 (A.C.A. § 4-7-506).

Point 3: Section 8-316 (A.C.A. § 4-8-316).

See Sections 8-302 (A.C.A. § 4-8-302), 8-308 (A.C.A. § 4-8-308) and 8-309 (A.C.A. § 4-8-309).

#### *Definitional Cross References:*

"Bona Fide Purchaser". Section 8-302 (A.C.A. § 4-8-302).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Indorsement". Section 8-308 (A.C.A. § 4-8-308).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Registered Form". Section 8-102 (A.C.A. § 4-8-102).

"Right". Section 1-201 (A.C.A. § 4-1-201).

No. 514, § 3(8-307), to incorporate the 1977 changes to this Uniform Commercial Code section.

\*This section was amended by Acts 1985,

### Comment to § 8-308 (A.C.A. § 4-8-308)\*

#### *Prior Uniform Statutory Provision:*

Sections 31 through 37, 64 through 69, Uniform Negotiable Instruments Law; Section 20, Uniform Stock Transfer Act.

#### *Purposes:*

1. The simplified method of indorsing certificated securities set forth in the Uniform Stock Transfer Act is continued in subsections (1) and (2) (A.C.A. § 4-8-308(1) and (2)). Although more than one special indorsement on a given certificated security is here made possible, the desire for dividends or interest, as the case may be, should operate to bring the security home for registration of transfer within a reasonable period of time. The usual form of assignment which appears in the back of a stock certificate or in a separate "power" may be filled up either in the form of an assignment, a power of attorney to transfer, or both. If it is not filled up at all but merely signed, the indorsement is in blank; if filled up either as an assignment or as a power of attorney to transfer, the indorsement is special.

2. Subsection (3) (A.C.A. § 4-8-308(3)) recognizes, in contradistinction to the rule under the Uniform Negotiable Instruments Law, the validity of a "partial" indorsement of a certificated security — e.g., as to fifty shares of the one hundred represented by a single certificate. The rights of a transferee under a partial indorsement to the status of a bona fide purchaser are left to the case law.

3. Subsections (4) and (5) (A.C.A. § 4-8-308(4) and (5)) together indicate that an instruction is an order from an "appropriate person" (subsection (7) (A.C.A. § 4-8-308(7))) to the issuer demanding registration of some form of transfer of an uncertificated security. Functionally, presentation of an instruction is quite similar to the presentation of an indorsed certificate for re-registration. The instruction may be in the form of a writing signed by an appropriate person or in any other form agreed upon in writing by the issuer

and an appropriate person. Allowing non-written forms of instructions will permit the development and employment of means of transmitting instructions electronically.

When a person originates an instruction in which he leaves a blank and the blank later is completed, subsection (5) (A.C.A. § 4-8-308(5)) gives the issuer the same rights it would have had against the originating person had that person completed the blank himself. This is true regardless of whether the person completing the instruction had authority to complete it. Compare Section 8-206 (A.C.A. § 4-8-206) and its Comment, dealing with blanks left upon issue.

4. Subsections (6) and (7) (A.C.A. § 4-8-308(6) and (7)) give basic rules for determining who is an appropriate person to indorse a certificated security or to originate a transfer instruction for an uncertificated security. Subsection (8) (A.C.A. § 4-8-308(8)) defines the various situations in which persons other than those designated in subsections (6) and (7) (A.C.A. § 4-8-308(6) and (7)) will also be "appropriate persons." The provisions are not mutually exclusive; for example, the same certificated security may be effectively indorsed either by the registered owner under subsection (6) (A.C.A. § 4-8-308(6)) or by his agent under (8)(f) (A.C.A. § 4-8-308(8)(f)). Paragraph (8)(a) (A.C.A. § 4-8-308(8)(a)) is made explicitly alternative to make it clear that there is no conflict with paragraph (3)(a) of Section 8-403 (A.C.A. § 4-8-403(3)(a)), permitting the issuer to rely on the continued power of a fiduciary to act where he is the registered owner and the issuer has not received written notice to the contrary. Similar protection is given to other persons dealing with the security. See also the Comment to Section 8-404 (A.C.A. § 4-8-404).

Paragraphs (e) and (f) (A.C.A. § 4-8-308(8)(e) and (f)) in particular are comprehensive. For example, where a "small es-



tate statute" permits a widow to transfer a decedent's securities without administration proceedings, she would be "a person having power to sign under applicable law." Similarly, in the usual partnership case, the signature of a partner would be that of "a person having power to sign under ... [a] ... controlling instrument."

Indorsement or origination by "an appropriate person" is included in the scope of the guarantee of signature (Section 8-312 (A.C.A. § 4-8-312)). It is prerequisite to the issuer's duty to register a transfer (Section 8-401 (A.C.A. § 4-8-401)) and to his exoneration from liability for improper registration (Section 8-404 (A.C.A. § 4-8-404)).

5. Subsection (9) (A.C.A. § 4-8-308(9)) makes clear that the indorser of a certificated security and the originator of an instruction do not warrant that the issuer will honor the underlying obligation. In view of the nature of the investment securities and the circumstances under which they are normally transferred, a transferor cannot be held to warrant as to the issuer's actions. As a transferor he, of course, remains liable for breach of the warranties set forth in this Article (Chapter) (Section 8-306 (A.C.A. § 4-8-306)).

6. Subsection (10) of this section (A.C.A. § 4-8-308(10)) makes the indorsement or instruction speak as of the date of signing. Section 8-312 (A.C.A. § 4-8-312) on guaranty of signature and Section 8-402 (A.C.A. § 4-8-402) on assurance that indorsements and instructions are effective apply the same reasoning. Thus, the signatures on a security indorsed by A during his lifetime or on behalf of X corporation by Y as president during his incumbency do not become "unauthorized" (Section 8-311 (A.C.A. § 4-8-311)) because A dies or Y is replaced as president by Z. Authority to deliver a certificated security and thus to complete the transfer is not covered by this section. Subsection (11) (A.C.A. § 4-8-308(11)) supplements Section 8-403(3)(b) (A.C.A. § 4-8-403(3)(b)) by making it clear that certain matters go to rightfulness of the transfer rather than to the validity of the indorsement or in-

struction. An example is the failure of a duly appointed guardian to obtain a required court approval of the transfer. Such a guardian is an "appropriate person" under paragraph (8)(c) of this section (A.C.A. § 4-8-308(8)(c)), and his indorsement may be effective even though, e.g., a required court order is not obtained.

#### *Cross References:*

Point 1: Section 8-306 (A.C.A. § 4-8-306).

Point 4: Section 8-312 (A.C.A. § 4-8-312) and Part 4 of this Article (Chapter).

Point 6: Sections 8-301 (A.C.A. § 4-8-301), 8-302 (A.C.A. § 4-8-302), 8-307 (A.C.A. § 4-8-307), 8-309 (A.C.A. § 4-8-309) and 8-312 (A.C.A. § 4-8-312).

#### *Definitional Cross References:*

"Bearer". Section 1-201 (A.C.A. § 4-1-201).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Honor". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Registered Form". Section 8-102 (A.C.A. § 4-8-102).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Sign". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 28(8-308), to incorporate the 1962 changes to this Uniform Commercial Code section, and by Acts 1985, No. 514, § 3(8-308), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-309 (A.C.A. § 4-8-309)\****Prior Uniform Statutory Provision:*

Section 30, Uniform Negotiable Instruments Law; Sections 1, 10, Uniform Stock Transfer Act.

*Purposes:*

1. There must be a voluntary parting with control in order to effect a valid transfer of a certificated security as between the parties. *Levey v. Nason*, 279 Mass. 268, 181 N.E. 193 (1932), and *National Surety Co. v. Indemnity Insurance Co. of North America*, 237 App.Div. 485, 261 N.Y.S. 605 (1933).

2. The provision in Section 10 of the Uniform Stock Transfer Act that an attempted transfer without delivery amounts to a promise to transfer is here omitted. Even under the prior Act the effect of such a promise was left to the applicable law of contracts, and this Article (Chapter) by making no reference to such situations intends to achieve a similar result.

With respect to delivery there is no counterpart to Section 8-307 (A.C.A. § 4-

8-307) on right to compel indorsements, such as is envisaged in *Johnson v. Johnson*, 300 Mass. 24, 13 N.E.2d 788 (1938), where the transferee under a written assignment was given the right to compel a transfer of the certificate.

*Cross References:*

Point 2: Section 8-307 (A.C.A. § 4-8-307).

See Sections 8-202(4) (A.C.A. § 4-8-202(4)) and 8-313 (A.C.A. § 4-8-313).

*Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Indorsement". Sections 8-308 (A.C.A. § 4-8-308).

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\*This section was amended by Acts 1985, No. 514, § 3(8-309), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-310 (A.C.A. § 4-8-310)\****Prior Uniform Statutory Provision:*

Section 40, Uniform Negotiable Instruments Law.

*Purposes:*

1. The concept of indorsement applies only to registered certificated securities, and a purported indorsement of bearer paper is normally of no effect.

An indorsement "for collection," "for surrender" or the like, charges a purchaser with notice of adverse claims (Section 8-304(1)(a) (A.C.A. § 4-8-304(1)(a))) but does not operate beyond this to interfere with any right the holder may otherwise possess to have the security registered in his name.

2. The provisions of Section 40 of the Negotiable Instruments Law as to the liability of special indorsers of bearer instruments have no applicability here since this Article (Chapter) negates the liability of indorsers as such upon the issuer's obligations (Section 8-308(9) (A.C.A. § 4-8-308(9))).

*Cross References:*

Sections 8-304 (A.C.A. § 4-8-304) and 8-308 (A.C.A. § 4-8-308).

*Definitional Cross References:*

"Adverse Claims". Section 8-302 (A.C.A. § 4-8-302).

"Bearer Form". Section 8-102 (A.C.A. § 4-8-102).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Indorsement". Section 8-308 (A.C.A. § 4-8-308).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Right". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985 No. 514 § 3(8-310), to incorporate the 1977 changes to this Uniform Commercial Code section.



**Comment to § 8-311 (A.C.A. § 4-8-311)\****Prior Uniform Statutory Provision:*

Section 23, Uniform Negotiable Instruments Law.

*Purposes:*

1. Most present day security purchases are made through brokers. The purchaser who normally receives and sees only a certificated security registered in his own name or an initial transaction statement addressed to him cannot realistically be held to have notice of or to have relied upon a forged or unauthorized indorsement on the original security transferred or upon the unauthorized instruction. A good faith purchaser who has received an initial transaction statement or a new, reissued or re-registered certificate is therefore protected. Compare *Telegraph Co. v. Davenport*, 97 U.S. 369, 24 L.Ed. 1047 (1878). That line of cases which has refused to apply this rule where the new security is still in the hands of the party to whom it was issued is expressly rejected. See *Weniger v. Success Mining Co.*, 227 F. 548 (C.C.A.Utah 1915); *Hambleton v. Central Ohio R.R. Co.*, 44 Md. 551 (1876).

2. The original owner of a security which has been transferred on the basis of a forged indorsement or instruction is protected by the issuer's liability for wrongful registration of transfer (Section 8-404 (A.C.A. § 4-8-404)). The issuer's duty to issue a similar security to the owner unless an overissue would result is made explicit in Part 4 of this Article (Chapter), as is his obligation to purchase available securities on the open market for transfer to the owner where overissue is involved (see Section 8-104 (A.C.A. § 4-8-104)). Compare *Prince v. Childs Co.*, 23 F.2d 605 (1928); *West v. Tintic Standard Mining Co.*, 71 Utah 158, 263 P. 490, 56 A.L.R. 1190 (1928). The issuer's recourse is against the forger and the guarantor of the latter's signature, if any. But since the

issuer has a right to require a guarantee of signature, a bona fide purchaser presenting the certificated security or instruction to the issuer should not be held liable on any implied warranty of title theory unless he knew of the forgery (Section 8-306 (A.C.A. § 4-8-306)).

3. A bond which has been registered as to principal and subsequently is returned to bearer form is, at that point, a "new security" within the meaning of this Section (A.C.A. § 4-8-311).

*Cross References:*

Point 2: Sections 8-104 (A.C.A. § 4-8-104), 8-306(1) (A.C.A. § 4-8-306(1)), 8-312 (A.C.A. § 4-8-312) and Part 4 of this Article (Chapter).

*Definitional Cross References:*

"Adverse Claim". Section 8-302 (A.C.A. § 4-8-302).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Good Faith". Section 1-201 (A.C.A. § 4-1-201).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-311), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-312 (A.C.A. § 4-8-312)\****Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. In subsection (1) (A.C.A. § 4-8-312(1)) the commonly accepted liability of

the guarantor of the signature of the indorser of a certificated security, which includes a warranty of the authority of the signer to sign for the holder as well as of the capacity of the signer to sign, is made express so that issuers and their agents may have a clear understanding of the

extent to which they may rely upon such guarantees.

2. Consistent with the coordinate provisions of Sections 8-308 (A.C.A. § 4-8-308), 8-401 (A.C.A. § 4-8-401) and 8-404 (A.C.A. § 4-8-404), this section (A.C.A. § 4-8-312) provides that a signature guarantor warrants as to facts "at the time of signing."

3. Subsection (2) (A.C.A. § 4-8-312(2)) sets forth the warranties that can reasonably be expected from the guarantor of the signature of the originator of an instruction, who, though familiar with the signer, does not have before him any evidence that the purported owner or pledgee is, in fact, the owner or pledgee of the subject uncertificated security. This is in contrast to the position of the person guaranteeing a signature on a certificate who can see a certificate in the signer's possession in the name of or indorsed to the signer or in blank. Thus, the warranty of appropriateness in clause (b) (A.C.A. § 4-8-312(2)(b)) is expressly conditioned on the actual registration's conforming to that represented by the originator. If the signer purports to be the owner or pledgee, the guarantor under clause (b) (A.C.A. § 4-8-312(2)(b)), warrants only his identity. If, however, the signer is acting in a representative capacity, the guarantor warrants both his identity and his authority to act for the purported owner or pledgee. The additional warranty of clause (d) (A.C.A. § 4-8-312(2)(d)) as to the taxpayer identification number is intended to prevent error or fraud resulting from identical or similar names. The warranties of subsection (2) (A.C.A. § 4-8-312(2)) are intended to provide satisfactory assurance to the issuer who needs no warranty as to the facts of registration because he can ascertain those facts from his own records.

4. Subsection (3) (A.C.A. § 4-8-312(3)) sets forth a "special guarantee of signature" under which the guarantor additionally warrants both registered ownership or pledge and freedom from undisclosed defects of record. The guarantor of the signature of an indorser of a certificated security effectively makes these warranties to a purchaser for value on the evidence of a clean certificate issued in the name of the indorser, indorsed to the indorser or indorsed in blank. By specially guaranteeing under subsection (3) (A.C.A. § 4-8-312(3)), the guarantor warrants

that the instruction will, when presented to the issuer, result in the requested registration free from defects not specified. It is contemplated that the special guarantee of signature will be used principally in brokerage transactions where the broker will be specially guaranteeing the signature on an instruction originated by his own customer. The broker's risk will be no greater than that of a broker who executes the sale of a security for his customer without the absolute assurance that his customer will deliver a clean certificate at settlement.

5. Subsection (4) (A.C.A. § 4-8-312(4)) makes clear that the warranties of a person guaranteeing a signature are limited to those specified in this section and do not include a general warranty of rightfulness. On the other hand subsections (5) and (6) (A.C.A. § 4-8-312(5) and (6)) make clear that a person guaranteeing an indorsement or an instruction does warrant that the transfer is rightful in all respects.

6. Subsection (7) (A.C.A. § 4-8-312(7)) makes clear what can be inferred from the combination of Sections 8-401 (A.C.A. § 4-8-401) and 8-402 (A.C.A. § 4-8-402), that the issuer may not require as a condition to transfer a guarantee of the indorsement or instruction nor may it require a special signature guarantee. But the voluntary furnishing of such a guarantee and its acceptance by the issuer may save the time and expense of an inquiry into possible adverse claims (cf. Section 8-403 (A.C.A. § 4-8-403)).

7. Subsection (8) (A.C.A. § 4-8-312(8)) is expressly designed to encourage issuers and their agents to rely upon signature guarantees and to avoid needless waste of time and duplication of effort in ascertaining the facts so guaranteed.

#### *Cross References:*

Point 1: Section 8-308 (A.C.A. § 4-8-308).

See Part 4 of this Article (Chapter).

#### *Definitional Cross References:*

"Appropriate Person". Section 8-308 (A.C.A. § 4-8-308).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Genuine". Section 1-201 (A.C.A. § 4-1-201).

"Indorsement". Section 8-308 (A.C.A. § 4-8-308).



"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Security Interest". Section 1-201 (A.C.A. § 4-1-201).

"Sign". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-312), to incorporate the 1977 changes to this Uniform Commercial Code section.

### Comment to § 8-313 (A.C.A. § 4-8-313)\*

#### *Prior Uniform Statutory Provision:*

Section 191, Uniform Negotiable Instruments Law; Section 22, Uniform Stock Transfer Act.

#### *Purposes:*

1. Subsection (1) (A.C.A. § 4-8-313(1)) lists the various methods by which legal rights in a security may be transferred from one person to another. Subsection (1) (A.C.A. § 4-8-313(1)) is expressly made applicable to limited interests, including security interests, as well as to entire interests. Compare Section 8-301(2) (A.C.A. § 4-8-301(2)). The word "only" in the first sentence is intended to provide that the methods of transfer listed are exclusive and that compliance with one of them is essential to a valid transfer. Transfers by operation of law are excepted because they are not transfers to a "purchaser".

2. This section is intended to bring the law of securities transfers into line with modern security trading practices and to allow for future development of those practices. It is recognized that most transfers are not effected through physical delivery of a certificate from seller to buyer, but rather through adjustments in balances of the parties' accounts with various intermediaries. Whether each intermediary has physical possession of a certificate to match every security it "holds" in its customer accounts is of no importance. So long as the intermediary exercises ultimate control, the securities may equally well take the form of an account with a securities depository, with another intermediary or with a transfer agent.

Thus a "financial intermediary," which as defined in subsection (4) (A.C.A. § 4-8-313(4)) must be a person that as part of the ordinary course of business "maintains security accounts" for its customers,

must control the disposition of securities pursuant to its customers' orders but may exercise its control in any of a number of forms — e.g. maintaining possession of certificated securities, being registered owner or registered pledgee of uncertificated securities, or having its own account with another financial intermediary. The important factor is that the intermediary must "hold" securities in an account for the customer. Notice that one who is a professional agent for holding securities accounts is not a financial intermediary with respect to any particular transaction in which it is not holding securities in an account for its customer. For example, a bank may as part of its business hold securities in accounts for its customers and therefore hold a financial intermediary with respect to those accounts; but if it takes a pledge of securities not held in account for the borrower to secure a loan, it is not a financial intermediary with respect to the securities pledged, since it holds the securities for its own account rather than for the customer. On the other hand, a broker is a financial intermediary with respect to a margin account, since even though it has a personal interest in the securities, it holds securities in an account for a customer.

3. Paragraphs (a) and (b) of subsection (1) (A.C.A. § 4-8-313(1)(a) and (b)) describe the most basic forms of transfer for certificated and uncertificated securities respectively. Paragraph (d) (A.C.A. § 4-8-313(1)(d)) is the basic provision for transfers effected through entries in the records of a financial intermediary. For a valid transfer to be effected there must be both an entry made in the records and a confirmation sent to the purchaser. Confirmation is required to ensure that evidence exists to prove that the securities are held

by the intermediary in a customer account rather than for its own account. This provision is important principally with regard to potential insolvency of an intermediary. So long as the financial intermediary holds the securities in an account, the form in which it "holds" the securities makes no difference to the effectuation of a transfer. The form does, however, make a difference as to whether the purchaser can become a bona fide purchaser. See subsection (2) (A.C.A. § 4-8-313(2)) and Section 8-302(1)(c) (A.C.A. § 4-8-302(1)(c)).

Paragraphs (e) and (f) of subsection (1) (A.C.A. § 4-8-313(1)(e) and (f)) provide for transfers of certificated and uncertificated securities held by a "third person" who is not a financial intermediary. Acknowledgement by that person that he holds for the purchaser is the only condition to the transfer. Requiring acknowledgement forces the transferee to have the arrangement made explicit.

Paragraph (g) (A.C.A. § 4-8-313(1)(g)) sets forth the requirements for a transfer of a security held by a clearing corporation. The transfer occurs when the appropriate entries are made. No confirmation is required, since the fact that a clearing corporation holds no securities for its own account eliminates the possibility that customers' securities might be intermingled with securities owned by the clearing corporation.

Paragraphs (h), (i) and (j) (A.C.A. § 4-8-313(1)(h), (i) and (j)) relate only to transfers of security interests. Paragraph (h) (A.C.A. § 4-8-313(1)(h)) is analogous to Section 9-305 (A.C.A. § 4-9-305), which provides the rule for perfecting a security interest in property in the possession of a bailee. Paragraph (h) (A.C.A. § 4-8-313(h)) makes explicit that if the transferor's interest is in an account with a financial intermediary, that intermediary is the proper person to receive notice of the transfer regardless of whether it has physical possession or registration in its own name or whether it has securities in an account with another intermediary. The notification to the "bailee" must be written and must be signed by the debtor or by the secured party, according to whether the security interest is being created or released. The transfer is also conditioned upon the existence of a written security agreement signed by the debtor

and adequately identifying the security. This requirement is included in paragraph (h) (A.C.A. § 4-8-313(1)(h)) because Section 8-321 (A.C.A. § 4-8-321), which sets forth the requirements for creation and perfection of security interests, gives no formality requirements other than the existence of a valid transfer.

Paragraph (i) (A.C.A. § 4-8-313(1)(i)) is similar to Section 9-304(4) (A.C.A. § 4-9-304(4)). Read in conjunction with Section 8-321 (A.C.A. § 4-8-321), it provides for "automatic" perfection for 21 days after new value is given with respect to a security interest as to which the debtor has signed a security agreement.

Paragraph (j) (A.C.A. § 4-8-313(1)(j)) also deals only with the creation of security interests. In conjunction with Section 8-321 (A.C.A. § 4-8-321), it provides that a financial intermediary that already controls disposition of a security may take a perfected security interest by giving value and having the debtor sign a security agreement.

4. Subsection (2) (A.C.A. § 4-8-313(2)) sets forth the principle that a purchaser is the owner of any security "held for him" — i.e., controlled pursuant to his instructions — by a financial intermediary. For example, a purchaser owns the securities in his custody account with a bank or his margin account with a broker. However, unless specific securities are separately identified as belonging to the purchaser, he cannot become a bona fide purchaser. A bona fide purchaser takes particular securities free of all claims and defenses. If bona fide purchaser status were given to those whose securities are held as part of a fungible bulk, there would be a possibility of inconsistent claims between two or more bona fide purchasers, since if the bulk should prove to be smaller than was expected, the claim of one or both must be compromised. An exception is made with respect to securities held by the clearing corporation, since the fact that those entities hold only for customer accounts makes the chance of inconsistent claims small. Securities held by intermediaries pursuant to paragraphs (c) and (d)(i) of subsection (1) (A.C.A. § 4-8-313(1)(c) and (d)(i)) are identifiable as belonging to a particular customer, and the customer therefore can be a bona fide purchaser. Those customers that are not bona fide purchasers own a proportionate property



interest in the bulk of securities of that nature held by the intermediary. Thus the group of customers together own the entire bulk, and in the event of insolvency of the intermediary they would as a group be secured to the extent the bulk covered their ownership claims. If the bulk were insufficient to provide each customer his full claim, each would share ratably.

5. Subsection (3) (A.C.A. § 4-8-313(3)) provides protection to both financial intermediary and customer whenever notice of an adverse claim is received after the intermediary takes delivery of a certificated security as a holder for value or after the transfer, pledge or release of an uncertificated security has been registered free of the claim to a financial intermediary. It also states the principle that as between the intermediary and its customer, the latter is entitled to a "clean" security, i.e. one as to which no notice of adverse claim has been received. *Isham v. Post*, 141 N.Y. 100, 35 N.E. 1084, 23 L.R.A. 90 (1894), which permitted a broker acting as agent to deliver to his customer a security as to which a claim of forgery was made after its receipt by the broker, is rejected. An intermediary is in the business of handling securities. It is better equipped to clear up any questions of genuineness or adverse claim, and even though it acts in whole or in part as agent for its customer, it is not permitted to pass such problems on to its customer. However if the problem arises because of the customer's own act or omission to act, he is estopped to rely on it as a basis for rejecting the security. Section 1-103 (A.C.A. § 4-1-103).

*Cross References:*

Sections 8-301 (A.C.A. § 4-8-301), 8-302 (A.C.A. § 4-8-302), 8-314 (A.C.A. § 4-8-314), 8-315 (A.C.A. § 4-8-315), 8-320 (A.C.A. § 4-8-320), 8-321 (A.C.A. § 4-8-321), 9-304(4) (A.C.A. § 4-9-304(4)) and 9-305 (A.C.A. § 4-9-305).

*Definitional Cross References:*

"Adverse Claim". Section 8-302 (A.C.A. § 4-8-302).

"Bona Fide Purchaser". Section 8-302 (A.C.A. § 4-8-302).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Clearing Corporation". Section 8-102 (A.C.A. § 4-8-102).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Fungible". Section 1-201 (A.C.A. § 4-1-201).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Indorsed". Section 8-308 (A.C.A. § 4-8-308).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Secured Party". Section 9-105 (A.C.A. § 4-9-105).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Security Agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security Interest". Section 1-201 (A.C.A. § 4-1-201).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 28(8-313), to incorporate the 1962 changes to this Uniform Commercial Code section, and by Acts 1985, No. 514, § 3(8-313), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-314 (A.C.A. § 4-8-314)\****Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. This section, together with the section on warranties to the purchaser (Section 8-306 (A.C.A. § 4-8-306)) and the section on transfer to the purchaser (Section 8-313 (A.C.A. § 4-8-313)), states the rights and duties of the parties involved in the transfer of a security from the original transferor to the ultimate purchaser. Particular emphasis has been placed upon transactions on organized exchanges or through brokers or dealers since they account for the great bulk of security sales. Normally the sale of a security on such an exchange or through brokers involves at least three intermediate transactions, and perhaps more, depending upon the number of correspondent brokers concerned. Rarely is the same security transferred through the entire transaction, and the duty of each intermediate party in the chain of transfer must therefore be stated. The increased use of clearing houses is also recognized — in subparagraph (1)(b)(iv) (A.C.A. § 4-8-314(1)(b)(iv)) a selling broker is specifically permitted to make delivery by clearing the sale through such a clearing agency.

2. Subparagraphs (1)(a)(i), (1)(a)(ii), (1)(b)(i) and (1)(b)(ii) (A.C.A. § 4-8-314(1)(a)(i), (1)(a)(ii), (1)(b)(i) and (1)(b)(ii)) set forth the basic methods of fulfilling the duty to transfer in exchange transactions. The selling customer can fulfill his duty by physically delivering a certificated security to the selling broker or by effecting the transfer of an uncertificated security to him on the records of the issuer. Similarly the selling broker can satisfy its duty to transfer to the buying broker by delivering a certificate or causing registration of an uncertificated security. Further, with respect to exchange transactions subparagraphs (a)(iv) and (b)(iii) of subsection (1) (A.C.A. § 4-8-314(1)(a)(iv) and (b)(iii)) provide that the duty to transfer can be conditionally satisfied by the delivery of an instruction. Such delivery does not constitute complete performance if the instruction is timely presented for registration and the issuer refuses to comply with its request. The burden of timely present-

ment is placed on the recipient of the instruction and it is not intended that instructions so given will circulate in the manner in which certificated securities now commonly circulate by indorsement. It is contemplated that this method of performance will be commonly employed in transactions settled through brokers, with, in many cases, the selling broker specially guaranteeing the signature of the originator of the instruction pursuant to Section 8-312(3) (A.C.A. § 4-8-312(3)).

3. Under subsection (2) (A.C.A. § 4-8-314(2)), absent agreement, one transferring a security to a purchaser in a transaction not consummated on an exchange or through brokers must either make physical delivery of a certificated security or cause the registration of transfer of an uncertificated security. Further, at the request of the purchaser he can satisfy his duty by causing acknowledgement to be given to the purchaser by a third person who controls the security (Section 8-313(1)(d) and (e) (A.C.A. § 4-8-313(1)(d) and (e))). He cannot, for example, just put a certificated security in transit and impose the risk of loss upon the recipient; nor can he fulfill his duty by delivering to the purchaser a transfer instruction.

4. Subsection (3) (A.C.A. § 4-8-314(3)) covers the situation in which one in business as a broker is, in the particular transaction, his own customer. When he buys or sells for a customer other than himself, whether as agent or as principal, he is a "broker" under this Article (Chapter) (Section 8-303 (A.C.A. § 4-8-303)) and the transaction is within subsection (1) of this section (A.C.A. § 4-8-314(1)).

*Cross References:*

Sections 8-303 (A.C.A. § 4-8-303), 8-306 (A.C.A. § 4-8-306) and 8-313 (A.C.A. § 4-8-313).

*Definitional Cross References:*

"Agreed". Section 1-201 (A.C.A. § 4-1-201).

"Broker". Section 8-303 (A.C.A. § 4-8-303).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Instruction". Section 8-308 (A.C.A. § 4-8-308).



"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-314), to incorporate the 1977 changes to this Uniform Commercial Code section.

### **Comment to § 8-315 (A.C.A. § 4-8-315)\***

#### *Prior Uniform Statutory Provision:*

Section 7, Uniform Stock Transfer Act.

#### *Purposes:*

1. This Section grants to all owners of securities — certificated or uncertificated — a remedy for wrongful transfer. The general rule permitting an owner to reclaim possession of a certificated security wrongfully transferred is continued in paragraph (1)(a) (A.C.A. § 4-8-315(1)(a)). Also, the owner of either a certificated or uncertificated security that has been wrongfully transferred may obtain a certificated security representing the same rights or may compel the origination of an effective transfer instructions for an uncertificated security comprising the same rights. Finally, the owner may have damages.

An exception is made, as in the prior law, in favor of bona fide purchasers. However, where the transfer is based upon a forged or unauthorized indorsement the exception operates in favor only of a good faith purchaser who is protected by Section 8-311 (A.C.A. § 4-8-311). See that section and the comments thereto.

2. This section is not intended to exclude any rights an owner may have to damages for conversion under the case law. But see Section 8-318 (A.C.A. § 4-8-318), which protects innocent brokers and other agents or bailees from liability for conversion.

#### *Cross References:*

Sections 8-302 (A.C.A. § 4-8-302), 8-311 (A.C.A. § 4-8-311) and 8-318 (A.C.A. § 4-8-318).

#### *Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Bona Fide Purchaser". Section 8-302 (A.C.A. § 4-8-302).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Indorsement". Section 8-308 (A.C.A. § 4-8-308).

"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Unauthorized Indorsement". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-315), to incorporate the 1977 changes to this Uniform Commercial Code section.

### **Comment to § 8-316 (A.C.A. § 4-8-316)\***

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

1. The registration of the transfer of a security is a matter of vital importance to a purchaser and he is here provided with

the means of obtaining such formal requirements for registration as signature guarantees, proof of authority, transfer tax stamps and the like. The transferor is the one in position to supply most conveniently whatever documentation may be requisite for registration of transfer, and

his duty to do so upon demand within a reasonable time is here stated affirmatively. But if the transfer is not for value the transferee should pay expenses. For these purposes a release from pledge by a secured party to a debtor is a transfer for value.

2. If the transferor's duty is not performed the transferee may reject or rescind the contract to transfer, pledge or release. He is not bound to do so — he may prefer his action for damages for breach of contract. If an essential item is peculiarly within the province of the transferor so that he is the only one who can obtain it, the purchaser may specifically enforce his right. Compare Section 8-307 (A.C.A. § 4-8-307).

*Cross Reference:*

Section 8-307 (A.C.A. § 4-8-307).

*Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable Time". Section 1-204 (A.C.A. § 4-1-204).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-316), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-317 (A.C.A. § 4-8-317)\***

*Prior Uniform Statutory Provision:*

Sections 13, 14, Uniform Stock Transfer Act.

*Purposes:*

1. In dealing with certificated securities the instrument itself is the vital thing, and therefore a valid levy cannot be made unless all possibility of the security's wrongfully finding its way into a transferee's hands has been removed. This can be accomplished only when the security is in the possession of a public officer, the issuer, or an independent third party. A debtor who has been enjoined can still transfer the security in contempt of court. See *Overlock v. Jerome-Portland Copper Mining Co.*, 29 Ariz. 560, 243 P. 400 (1926). Therefore, although injunctive relief is provided in subsection (6) (A.C.A. § 4-8-317(6)) so that creditors may use this method to gain control of the security, the security itself must be reached to constitute a proper levy whenever the debtor has possession. The method used in *Hodes v. Hodes*, 176 Or. 102, 155 P.2d 564 (1945), where the Oregon court enjoined the transfer of a security in a safe deposit box in the state of Washington, directing a copy of the writ to be served upon the issuer, although not operative as an effective levy, is a method of reaching the security approved by the section.

2. Whenever the security is not in the form of a negotiable instrument in the debtor's possession, an effective levy can be made by serving process upon the person controlling transfer. Thus subsection (2) (A.C.A. § 4-8-317(2)) provides that when the security is uncertificated and registered in the debtor's name — or, what in effect is the same situation, whenever a certificated security is in the issuer's possession (Section 8-102(1)(c) (A.C.A. § 4-8-102(1)(c))) — levy can be made only by serving process upon the issuer. The most logical place to serve the issuer would be the place where the transfer records are maintained, but that location might be difficult to identify, especially when the separate elements of a computer network might be situated in different places. The chief executive office is selected as the appropriate place by analogy to Section 9-103(3)(d) (A.C.A. § 4-9-103(3)(d)). See Comment (5)(c) to that section.

This section indicates only how attachment is to be made, not when it is legally justified. For that reason there is no conflict between this section and *Shaffer v. Heitner*, 433 U.S. 186, 97 S.Ct. 2569, 53 L.Ed.2d 683 (1977).

3. An attachment filed at the issuer's office against certificated securities is ineffective unless the security itself has been surrendered to the issuer. The case



law holdings that priority in time of transfer or attachment governed the validity of the levy are rejected under this Article (Chapter) as under the Stock Transfer Act. See for example, *National Bank of the Pacific v. Western Pac. R. Co.*, 157 Cal. 573, 108 P. 676, 27 L.R.A., N.S., 987, 21 Ann.Cas. 1391 (1910).

4. Subsection (3) (A.C.A. § 4-8-317(3)) provides that when a security, either certificated or uncertificated, is controlled by a secured party, an effective lien can be established by service on the secured party. This section does not attempt to provide for rights as between the creditor and the secured party, as, for example, whether or when the secured party must liquidate the security.

Subsection (4) (A.C.A. § 4-8-317(4)) recognizes that securities are frequently held in account for customers by banks or brokers and that such securities may be registered not only in the name of the debtor but, more commonly, in street or other nominee name. Additionally, in such cases, the securities may have been commingled, repledged or deposited so that no particular security could be identified as that of the debtor. The subsection provides that the debtor's account can be reached by process upon the entity upon whose books the interest of the debtor appears. This appears to be the most effective way of preventing the transfer of the debtor's interest and thus protecting the creditor. It is only that entity that is aware of the debtor's interest, irrespective of where the securities are located or in what name they happen to be registered.

Subsection (5) (A.C.A. § 4-8-317(5)) expressly provides that securities in which the debtor's interest is reached pursuant to subsection (3) or (4) (A.C.A. § 4-8-317(3) or (4)) may be transferred for new value, free of the creditor's lien, but also provides that when and if they are transferred, the lien will be transferred to the proceeds. Nothing in subsection (5) (A.C.A. § 4-8-317(5)) is intended to validate any transfer that would otherwise constitute a fraudulent conveyance. Furthermore, subsection (5) (A.C.A. § 4-8-317(5)) is expressly subject to the proce-

dural laws of the states, and no attempt has been made to prescribe the consequences of obtaining such a lien or the procedures for its enforcement.

5. Particular terms to describe creditor's process have been avoided in this section. This section is not intended to have any effect on the availability of garnishment or similar third-party process as a pre-judgment or post-judgment remedy. Cf. *Snidach v. Family Finance Corp.*, 395 U.S. 337, 23 L.Ed.2d 349, 89 S.Ct. 1820 (1969); *Fuentes v. Shevin*, 407 U.S. 67, 32 L.Ed.2d 556, 92 S.Ct. 1983 (1972); *Mitchell v. W. T. Grant Co.*, 416 U.S. 600, 40 L.Ed.2d 406, 94 S.Ct. 1895 (1974). Such matters are a proper concern of the procedural rules of the states, subject, of course, to constitutional limitations.

6. This section deals with the problems of attaching or levying creditors. It does not apply in cases where a governmental agency, for reasons of public safety or the like, seeks to confiscate securities. See, for example, the situation in *Silesian American Corp. v. Clark*, 332 U.S. 469, 68 S.Ct. 179, 92 L.Ed. 81 (1947), upon which this section has no bearing.

#### *Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Financial Intermediary". Sections 8-313 (A.C.A. § 4-8-313).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Secured Party". Section 9-105 (A.C.A. § 4-9-105).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-317), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-318 (A.C.A. § 4-8-318)\****Prior Uniform Statutory Provision:*

None.

*Purposes:*

This Section negates the liability of agents, including brokers, and of bailees for innocent conversion or participation in breach of fiduciary duty. *Gruntal v. National Surety Co.*, 254 N.Y. 468, 173 N.E. 682 (1930) is followed. Compare Section 7(a) of the Uniform Act for Simplification of Fiduciary Security Transfers.

Notice that the concept of a good faith includes the objective element of observing reasonable commercial standards when the agent or bailee is in the business of dealing with securities.

*Cross Reference:*

Section 7-404 (A.C.A. § 4-7-404).

*Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Good Faith". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-318), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-319 (A.C.A. § 4-8-319)\****Prior Uniform Statutory Provision:*

Section 4, Uniform Sales Act (which was based on Section 17 of the statute of 29 Charles II).

*Purposes:*

1. This Section is intended to conform the statute of frauds provisions with regard to securities to the policy of the like provisions in Article 2 (Chapter 2) Section 2-201 (A.C.A. § 4-2-201). The chief difference is that this Section requires that quantity and price be specified.

2. What will be sufficient specification will vary with the circumstances. Where the transaction is on an exchange or an over-the-counter market where daily quotations of the security are available "100 shares X. Corp. comm. at market" should suffice. If there is no readily available standard to interest "at market" there is no "defined or stated price."

3. Paragraph (b) (A.C.A. § 4-8-319(b)) sets forth several actions which, if taken by a transferee, constitute manifestation of intent to purchase. The person receiving an initial transaction statement is given a period of 10 days to subject, since there is no overt manifestation of intent. While acceptance of delivery of a certificate or instruction is seen as an overt manifestation so that there is no grace period, in practice there will often be a

question as to what constitutes acceptance by an organization. Failure to object to delivery within a reasonable period will be a factor to consider. Making payment is a more definite indication of intent.

4. Paragraph (c) (A.C.A. § 4-8-319(c)) is particularly important in the relationship of broker (Section 8-303) (A.C.A. § 4-8-303)) and customer. Normally a great volume of such business is done over the telephone. Orders are executed almost immediately and confirmed on the same or next business day, usually on standard forms which as to the broker more than meet the minimal requirements of paragraph (a) (A.C.A. § 4-8-319(a)). It is reasonable to require the customer to raise his objection, if any, within ten days after the confirmation has been received (Section 1-201 (A.C.A. § 4-1-201)).

*Cross Reference:*

Section 2-201 (A.C.A. § 4-2-201).

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Broker". Section 8-303 (A.C.A. § 4-8-303).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Contract". Section 1-201 (A.C.A. § 4-1-201).



"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable Time". Section 1-204 (A.C.A. § 4-1-204).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-319), to incorporate the 1977 changes to this Uniform Commercial Code section.

### Comment to § 8-320 (A.C.A. § 4-8-320)\*

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

1. Consistent with the underlying purposes and policies of this Act "to permit the continued expansion of commercial practices through custom, usage and agreement of the parties" — subsection (2)(b) of Section 1-102 (A.C.A. § 4-1-102(2)(b)) — this Section expressly authorizes a newly developing and commercially useful method of transferring or pledging securities on the organized securities markets, particularly among brokers and banks but not necessarily so limited. A clearing corporation is a special kind of financial intermediary. It holds securities on deposit from brokers, banks and other financial institutions, and clears trades among its depositors by making entries on its records. This section sets forth rules for determining when such entries are effective to constitute a transfer (Section 8-313(1)(g) (A.C.A. § 4-8-313(1)(g))).

The basic requirements, outlined in subsection (1) (A.C.A. § 4-8-320(1)), are that the security ultimately be subject to the control of the clearing corporation making the entries and that the security be in a form that would allow the clearing corporation (or a person acting subject to its orders) to have a new security registered in the name of, and transferred to, a purchaser. The latter requirement is specified in some detail. A certificated security must be in the custody of either the clearing corporation making the entries, an-

other clearing corporation, a custodian bank or nominee; and it must be either in bearer form, registered in the name of the clearing corporation (or of one of the clearing corporations if there are more than one involved), or else indorsed so that the clearing corporation (or one of them) could obtain registration of a transfer from the issuer. (The phrase "registered in the name of the clearing corporation" in subparagraph (1)(a)(ii) (A.C.A. § 4-8-320(1)(a)(ii)) should be interpreted liberally so as to include restrictive indorsements and also to include registration or indorsement to either of the clearing corporations.) An uncertificated security must be registered in the name of a clearing corporation, a custodian bank or a nominee.

The requirement that the security be subject to the control of the clearing corporation means that if a certificated security is in the custody of, or an uncertificated security is registered in the name of, another clearing corporation or a custodian bank, the clearing corporation on whose records the entries in question are made must have the right to give orders to that person as to how and when to dispose of the security. That right may be an indirect one — for example, a security is subject to the control of Clearing Corporation A if the security is certificated and has been deposited in A's account with Clearing Corporation B, which in turn has deposited the security in its account with C, which may be either another clearing corporation or a custodian bank. Clearing

Corporation A can give orders to B which in turn can give orders to C.

2. Subsection (2) (A.C.A. § 4-8-320(2)) makes clear that securities of the same issue may be treated as fungible interests, and that entries may be merely debits and credits to the accounts of the participants.

3. Subsection (4) (A.C.A. § 4-8-320(4)) makes clear that transfer, pledge or release under this Section does not affect the registration of ownership or pledge on the issuer's records.

Subsection (5) (A.C.A. § 4-8-320(5)) states that the entries made pursuant to this Section are effective to transfer the subject securities regardless of the fact that the entries were not appropriate. A person wronged by an inappropriate transfer may pursue his remedies against the transferee and against the clearing corporation. The nature of the rights between the clearing corporation and its participants is left to private contract and case law. See Section 8-315 (A.C.A. § 4-8-315) as to actions against the transferee.

#### *Cross References:*

Sections 1-102(2)(b) (A.C.A. § 4-1-102(2)(b)), 8-301 (A.C.A. § 4-8-301), 8-302 (A.C.A. § 4-8-302), 8-313 (A.C.A. § 4-8-313), 8-315 (A.C.A. § 4-8-315) and 8-321 (A.C.A. § 4-8-321).

#### *Definitional Cross References:*

"Appropriate Person". Section 8-308 (A.C.A. § 4-8-308).

"Bearer Form". Section 8-102 (A.C.A. § 4-8-102).

"Bona Fide Purchaser". Section 8-302 (A.C.A. § 4-8-302).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Clearing Corporation". Section 8-102 (A.C.A. § 4-8-102).

"Custodian Bank". Section 8-102 (A.C.A. § 4-8-102).

"Fungible". Section 1-201 (A.C.A. § 4-1-201).

"Indorsed". Section 8-308 (A.C.A. § 4-8-308).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Security Interest". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-320), to incorporate the 1977 changes to this Uniform Commercial Code section.

### **Comment to § 8-321 (A.C.A. § 4-8-321)**

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

1. This section is intended to govern the creation, perfection and termination of security interests in all securities, certificated and uncertificated. Subsection (1) (A.C.A. § 4-8-321(1)) requires an effective transfer under Section 8-313(1) (A.C.A. § 4-8-313(1)) as formal evidence of the security interest. The requirement that there be formal evidence of the creation of a security interest in collateral other than securities can be satisfied by having the debtor sign a security agreement or by having the secured party take possession of the collateral. Section 9-203 (A.C.A. § 4-9-203). Transfers pursuant to paragraphs (a)-(g) of Section 8-313(1) (A.C.A.

§ 4-8-313(1)(a)-(g)) all involve either delivery to the secured party or else some other specific event that is the functional equivalent of delivery. Transfers pursuant to paragraphs (h)-(j) (A.C.A. § 4-8-313(1)(h)-(j)) do not involve any event that serves that function, but they require a security agreement signed by the debtor.

2. Subsection (2) (A.C.A. § 4-8-321(2)) provides that when value has been given and the debtor has rights in the collateral, an appropriate transfer will result not only in an enforceable security interest but also in one that is perfected. Under this section, an unperfected security interest in a security cannot be created. A security interest created by transfer under Section 8-313(1)(i) (A.C.A. § 4-8-313(1)(i)), however, may become



unperfected if, within 21 days, the requirements of another method of effective transfer are not satisfied.

3. Subsection (3) (A.C.A. § 4-8-321(3)) expressly makes a security interest in securities subject to the provisions of Article 9 (Chapter 9) except those provisions dealing with the creation and perfection of security interests. Those matters are governed by this section. In addition, the provisions of Section 9-207 (A.C.A. § 4-9-207), which govern the rights and duties of a pledgee of a certificated security, are extended, to the extent they are applicable, to all secured parties, whether or not the possession of a certificated security is involved. Thus, in the absence of agreement to the contrary, the secured party, who might be the registered owner of an uncertificated security, would have the duty to remit dividends he received to the debtor or to apply them in reduction of the obligation under Section 9-207(2)(c) (A.C.A. § 4-9-207(2)(c)).

4. Subsection (4) (A.C.A. § 4-8-321(4)) provides that a security interest is terminated by retransfer to the debtor unless the parties otherwise agree. Even when the parties agree that the security interest is to continue, it will become unperfected unless there is delivery of a

certificated security for the limited purposes described in the second sentence. Compare Section 9-304(5) and (6) (A.C.A. § 4-9-304(5) and (6)).

#### *Cross References:*

Sections 8-313 (A.C.A. § 4-8-313) and 9-203 (A.C.A. § 4-9-203). See generally Article 9 (Chapter 9).

#### *Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Secured Party". Section 9-105 (A.C.A. § 4-9-105).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Security Agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security Interest". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

### **Comment to § 8-401 (A.C.A. § 4-8-401)\***

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

1. Section 8-201(3) (A.C.A. § 4-8-201(3)) defines "issuer" as used in this Part 4 as the person on whose behalf transfer books are maintained. Transfer agents, registrars or the like have rights and duties under this Part within the scope of their respective functions, similar to those of the issuer (Section 8-406 (A.C.A. § 4-8-406)).

2. There is a substantial and heterogeneous body of case law as to the issuer's duty to register a transfer and as to his liability for improper registration, e.g., on an unauthorized signature (Section 8-311 (A.C.A. § 4-8-311)), or where the indorsement is not that of an appropriate person. (Section 8-308 (A.C.A. § 4-8-308)), and generally under circumstances where the issuer is deemed to have had notice of an adverse claim (Section 8-302 (A.C.A. § 4-

8-302)) and thus of the possible wrongfulness of the transfer.

In general this section and those which follow it continue the well-settled rules found in the case law as to duty to register and as to liability for improper registration on an unauthorized signature, or where the indorsement is not that of an appropriate person. They also extend the application of those rules to uncertificated securities.

In all other areas, the issuer's potential liability for wrongful registration of transfer has been substantially reduced. The rules found in the case law are drastically modified in furtherance of a considered policy to speed up the registration process by narrowing the field in which the issuer historically has first sought to assure itself that it cannot be held to be on notice of an adverse claim, and, failing that assurance, has imposed rigorous requirements of proof that there is no possible impropriety.

3. This section states the basic duty of the issuer to register transfers. It states that a duty exists, but only if certain preconditions exist. If any of the preconditions do not exist, there is no duty to register transfer. If the indorsement on a security is a forgery, there is no duty. If the instruction to transfer an uncertificated security is not originated by an appropriate person, there is no duty. If there has not been compliance with applicable tax laws, there is no duty. If the security is properly indorsed but nevertheless transfer is in fact wrongful, there is no duty unless the transfer is to a bona fide purchaser (and the other preconditions exist). Cf. *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F.2d 838 (2d Cir. 1952), cert. denied, 73 S.Ct. 89, 344 U.S. 856, 97 L.Ed. 664.

This section does not constitute a mandate that all preconditions must be met before the issuer registers a transfer. If it so desires, the issuer can waive the reasonable assurances specified in paragraph (b) (A.C.A. § 4-8-401(1)(b)). If it has confidence in the responsibility of the persons requesting transfer, it can ignore questions of compliance with tax laws. If it has no duty to inquire into or otherwise recognize adverse claims, it can and it should register transfer without inquiry as to the rightfulness of a transfer.

Sections 8-402 (A.C.A. § 4-8-402) and 8-403 (A.C.A. § 4-8-403) are the sections dealing with the specific rules as to assurances and duty to inquire.

4. By subsection (2) (A.C.A. § 4-8-401(2)) the person entitled to registration may not only compel it but may hold the issuer liable in damages for unreasonable delay.

5. See Section 8-404 (A.C.A. § 4-8-404) as to the issuer's liability for wrongful registration of transfer.

#### *Cross References:*

Point 1: Sections 8-201(3) (A.C.A. § 4-8-201(3)) and 8-406 (A.C.A. § 4-8-406).

Point 2: Sections 8-204 (A.C.A. § 4-8-204), 8-301 (A.C.A. § 4-8-301), 8-308 (A.C.A. § 4-8-308) and 8-311 (A.C.A. § 4-8-311).

#### *Definitional Cross References:*

"Adverse Claim". Section 8-302 (A.C.A. § 4-8-302).

"Appropriate Person". Section 8-308 (A.C.A. § 4-8-308).

"Bona Fide Purchaser". Section 8-302 (A.C.A. § 4-8-302).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Genuine". Section 1-201 (A.C.A. § 4-1-201).

"Indorsement". Section 8-308 (A.C.A. § 4-8-308).

"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Registered Form". Section 8-102 (A.C.A. § 4-8-102).

"Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3(8-401), to incorporate the 1977 changes to this Uniform Commercial Code section.

### **Comment to § 8-402 (A.C.A. § 4-8-402)\***

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

1. As is noted in the Comment to Section 8-401 (A.C.A. § 4-8-401), the issuer is absolutely liable for wrongful registration of transfer when the signature of the indorser is unauthorized or is not that of an appropriate person or when an instruction is not originated by an appropriate person. The issuer is entitled to require such assurance as is reasonable under the circumstances that all necessary

indorsements are effective, and thus to minimize its risk. This section establishes the requirements the issuer may make in terms of documentation which, except in the rarest of instances, should be easily furnished. If a demand for further assurance is reasonable under the circumstances, subsection (4) (A.C.A. § 4-8-402(4)) applies.

2. Under subsection (1)(a) (A.C.A. § 4-8-402(1)(a)) the issuer may require in all cases a guarantee of signature (Section 8-312 (A.C.A. § 4-8-312)). When an instruction is presented the issuer always



may require either a warranty of taxpayer identification number or some other reasonable assurance as to the identity of the originator. Subsection (2) (A.C.A. § 4-8-402(2)) allows the issuer to require that the person making these guarantees be one reasonably believed to be responsible, and the issuer may adopt standards of responsibility which are not manifestly unreasonable. In this aspect this section approves the practice of the organized securities markets.

3. This section, by paragraphs (b) through (e) of subsection (1) (A.C.A. § 4-8-402(1)(b) through (e)), permits the issuer to seek confirmation of the effectiveness of the indorsement or instruction. The permitted methods act as a double check on matters which are within the warranties of the guarantor of signature. See Section 8-312 (A.C.A. § 4-8-312). In addition, to some extent they act also as a check on the right to transfer (i.e., to deliver the indorsed certificated security or to transmit an instruction). Thus, an agent may be required to submit his power of attorney, a corporation to submit a certified resolution evidencing the authority of its signing officer to sign, an executor or administrator to submit the usual "short-form certificate", etc. But failure of a fiduciary to obtain court approval of the transfer or to comply with other requirements does not make his signature unauthorized. Section 8-308(11) (A.C.A. § 4-8-308(11)). Hence, court orders and other controlling instruments are omitted from subsection (1) (A.C.A. § 4-8-402(1)).

Subsection (1)(c) (A.C.A. § 4-8-402(1)(c)) authorizes the issuer to require "appropriate evidence" of appointment or incumbency, and subsection (3) (A.C.A. § 4-8-402(3)) indicates what evidence will be "appropriate". In the case of a fiduciary appointed or qualified by a court that evidence will be a court certificate dated within sixty days before the date of presentation. Where the fiduciary is not appointed or qualified by a court, as in the case of a successor trustee, subsection (3)(b) (A.C.A. § 4-8-402(3)(b)) applies. Compare Section 4 of the Uniform Act for Simplification of Fiduciary Security Transfers. If the security is registered in the name of the fiduciary, the issuer may under Section 8-403(3)(a) (A.C.A. § 4-8-403(3)(a)) assume without inquiry that

the fiduciary status continues until written notice to the contrary is received. Hence, no evidence of appointment or incumbency is needed unless such a notice has been received. Compare Section 2 of the Uniform Act for the Simplification of Fiduciary Security Transfers.

Where subsection (3)(b) (A.C.A. § 4-8-402(3)(b)) applies, the issuer may require a copy of a trust instrument or other document showing the appointment, or it may require the certificate of a responsible person. In the absence of such a document or certificate, it may require other appropriate evidence. If a document is obtained solely as "appropriate evidence of appointment or incumbency" under subsection (3)(b) (A.C.A. § 4-8-402(3)(b)), the issuer is not charged with notice of its contents except to the extent that the contents relate directly to the appointment or incumbency. But if the document is obtained for any other purpose, the issuer may be charged under subsection (4) (A.C.A. § 4-8-402(4)). See Point 6 below.

4. There are many other types of situations where, under the case law, the issuer would be deemed to have notice of possible adverse claim, and therefore would register transfer at its peril. Typical are: knowledge that the registered owner is dead, the fact that he is described or identifiable as a fiduciary, etc. Perhaps the most ubiquitous is where a will, trust indenture or other controlling instrument is on file with the issuer or transfer agent for some other purpose (e.g., in the banking as distinct from the corporate agency department of a trust company), but, unless specifically asked for, would not come to the attention of the officers responsible for the registration of security transfers. Here, under the cases, there is an area of liability based upon notice of possible adverse claims affecting the right to deliver the security, an area to which the warranties of the guarantor of signature specifically do not extend. See Section 8-312(4) (A.C.A. § 4-8-312(4)). Also it is the area in which in the past issuers and their agents, fearing possible lawsuits based upon unauthorized transfers by fiduciaries and the like, have made it a practice to demand complete and convincing evidence that the transfer is proper in all of its aspects. Sections 8-403 (A.C.A. § 4-8-403) and 8-404 (A.C.A. § 4-8-404) strictly cir-

cumscribe the issuer's liability in such cases, and this section therefore makes no provisions for assurances to cover them.

5. Circumstances may indicate that a necessary signature was unauthorized or was not that of an appropriate person. Such circumstances would be ignored at risk of absolute liability, and to minimize that risk the issuer may properly exercise the option given by subsection (4) (A.C.A. § 8-4-402(4)) to require assurance beyond that specified in subsection (1) (A.C.A. § 4-8-402(1)). On the other hand, the facts at hand may reflect only on the rightfulness of the transfer. Such facts do not operate, as they did under prior law, automatically to create a duty of inquiry, unless there is timely notification of the existence of an adverse claim. See Section 8-403(1) and (4) (A.C.A. § 4-8-403(1) and (4)). If there is a duty of inquiry under Section 8-403 (A.C.A. § 4-8-403), the issuer may follow the procedure provided in Section 8-403(2) or (5) (A.C.A. § 4-8-403(2) or (5)), or it may discharge the duty of inquiry as to a certificated security "by any reasonable means". The same is true if the issuer's overriding duty to conduct its functions in good faith (Section 1-203 (A.C.A. § 4-1-203)) comes into play — e.g., where the certificates security is indorsed or the instruction is originated by a person known to the employee handling the transaction for the issuer to be wanted by the police.

6. Specifically to implement the policy of this Act to discourage issuers from requiring excessive documentation, subsection (4) (A.C.A. § 4-8-402(4)) provides that if the issuer elects to require additional documentation for any purpose other than to obtain "appropriate evidence of appointment or incumbency" under subsection (3)(b) (A.C.A. § 4-8-402(3)(b)) and both requires and obtains a copy of a will, trust, indenture, article of co-partnership, by-laws or other controlling instrument, it is charged with notice of all matters contained therein affecting the transfer. It follows that an instrument voluntarily submitted, without having been "re-

quired" by the issuer, may be returned without examination.

But if the issuer has no duty to inquire and demands more than reasonable assurance that the instruction or the necessary indorsements are genuine and effective, the presenter of the instruction or the certificated security may refuse the demand and sue for improper refusal to register Section 8-401 (A.C.A. § 4-8-401).

#### *Cross References:*

Point 1: Sections 8-308 (A.C.A. § 4-8-308) and 8-311 (A.C.A. § 4-8-311).

Point 2: Section 8-312 (A.C.A. § 4-8-312).

Point 3: Sections 8-308 (A.C.A. § 4-8-308) and 8-312 (A.C.A. § 4-8-312).

Point 4: Sections 8-312 (A.C.A. § 4-8-312), 8-403 (A.C.A. § 4-8-403) and 8-404 (A.C.A. § 4-8-404).

Point 5: Sections 1-203 (A.C.A. § 4-1-203) and 8-403 (A.C.A. § 4-8-403).

Point 6: Section 8-401 (A.C.A. § 4-8-401).

#### *Definitional Cross References:*

"Adverse Claim". Section 8-302 (A.C.A. § 4-8-302).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Genuine". Section 1-201 (A.C.A. § 4-1-201).

"Indorsement". Section 8-308 (A.C.A. § 4-8-308).

"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-402), to incorporate the 1977 changes to this Uniform Commercial Code section.



**Comment to § 8-403 (A.C.A. § 4-8-403)\****Prior Uniform Statutory Provision:*

Section 3, Uniform Fiduciaries Act.

*Purposes:*

1. In consonance with the general policy of this Part 4 (See the Comments to Section 8-401 (A.C.A. § 4-8-401) and 8-402 (A.C.A. § 4-8-402)), and subject always to the overriding duty of good faith in the performance of its functions (Section 1-203 (A.C.A. § 4-1-203) this section limits the issuer's duty as to adverse claims to the specific situations stated in subsections (1) (A.C.A. § 4-8-403(1)) as to certificated securities and (4) (A.C.A. § 4-8-403(4)) and as to uncertificated securities.

Paragraph (a) of subsection (1) (A.C.A. § 4-8-403(1)(a)) is the ordinary "stop transfer" notice commonly resorted to by the owner of a lost or stolen certificated security or in a situation where breach of trust, disregard of a valid restriction on transfer, or other improper action is feared to have occurred or to be about to occur.

Notification under paragraph (a) of subsection (1) (A.C.A. § 4-8-403(1)(a)) must be "written" (Section 1-201(46) (A.C.A. § 4-1-201(46))) and must be "received" (Section 1-201(26) (A.C.A. § 4-1-201(26))) "at a time and in a manner which affords the issuer a reasonable opportunity to act on it prior to the issuance of a new, reissued or re-registered security." Cf. Section 1-201(27) (A.C.A. § 4-1-201(27)). Its contents must be such as to make reasonably clear who makes the claim and with respect to what security, and where communications may be addressed to him. Compare Section 5(a) of the Uniform Act for Simplification of Fiduciary Security Transfers.

A notification once so received is easily keyed to the appropriate records. Therefore, no defense of "forgotten notice", possibly relevant on the issue of bona fide purchase as to bearer form securities, is available under this section.

As to paragraph (b) (A.C.A. § 4-8-403(1)(b)) see the Comment to Section 8-402 (A.C.A. § 4-8-402).

2. With respect to certificated securities subsection (2) (A.C.A. § 4-8-403(2)) does not limit the issuer to any specific method of discharging a duty of inquiry. It

may use "any reasonable means" including the procedure spelled out in the subsection. That procedure, based on a New York statute respecting adverse claims to bank deposits and on commercial practice, should be effective in the large majority of cases to protect the rights of all interested parties and relieve the issuer of further responsibility. No delay during the thirty day period will be "reasonable" under Section 8-401(2) (A.C.A. § 4-8-401(2)).

3. Subsection (3) (A.C.A. § 4-8-403(3)) is the converse of subsection (1) (A.C.A. § 4-8-403(1)) and spells out some specific situations in which under prior law a duty to inquire existed or may have existed. Compare Sections 2 and 3 of the Uniform Act for Simplification of Fiduciary Security Transfers. As to the effect of subsection (3)(a) (A.C.A. § 4-8-403(3)(a)) on the effectiveness of an indorsement, see the Comment to Section 8-404 (A.C.A. § 4-8-404).

4. Transfer of uncertificated securities does not take place until registration, so that any mandated delay seriously impairs an owner's ability to sell or pledge his security. Since a prudent purchaser may not pay unless he receives a clean initial transaction statement, the effect of a rule giving the issuer a duty to inquire any time it received any written notice of an adverse claim, however frivolous, would be disastrous. Because of this important difference between certificated and uncertificated securities, there are separate provisions as to duty to inquire. Subsections (4), (5), (6) and (7) (A.C.A. § 4-8-403(4), (5), (6) and (7)) apply only to uncertificated securities, and are intended to accommodate the interests of owners, purchasers, issuers and adverse claimants.

Subsection (4) (A.C.A. § 4-8-403(4)) states that an issuer has no duty as to adverse claims except in four described situations. Mere written notifications result in a duty only when they come from existing owners and pledgees and are analogous to stop payment orders on checks. There is a duty as to claims to which the security was subject when it was purchased by the present owner, a situation with which the owner is already familiar. There is a duty as to claims

arising from the issuer's request for documentation under Section 8-402 (A.C.A. § 4-8-402).

The significant difference of subsection (4) (A.C.A. § 4-8-403(4)) from subsection (1) (A.C.A. § 4-8-403(1)) is that claims asserted by third parties, in order to impose a duty on the issuer, must be supported by legal process. This will constitute assurance that the claim is not merely frivolous and that its assertion is more than harassment. In most cases the owner will have been notified and have had the opportunity to be heard. While claims thus asserted may ultimately be adjudged invalid, the owner will not be tied up by a bare written communication from the claimant. On the other hand, while a more substantial burden is imposed on the claimant, there is a channel through which he can assert his claim before the rights of a bona fide purchaser intervene.

If the claimant sues the owner in a court that has no jurisdiction over the issuer and an injunction is issued against the owner forbidding him to transfer the security, the issuer has a duty under paragraph (4)(a) (A.C.A. § 4-8-403 (4)(a)) if it receives an authenticated copy of the order. Even though in that situation the order is not directed to the issuer, it is "legal process served upon the issuer" for purposes of paragraph (4)(a) (A.C.A. § 4-8-403(4)(a)). There is sufficient guarantee that the complaint is not frivolous. Further, the issuer might breach its duty to act in good faith if it registered a transfer in spite of such clear evidence of impropriety.

5. Once it is established that the claim imposes a duty on the issuer, notations of the claim must be contained in all statements sent with respect to the security, and registration of transfer or pledge must be refused unless the nature of the claim is consistent with transfer or pledge subject to the claim. When transfer or pledge is registered subject to the claim, subsection (6) (A.C.A. § 4-8-403(6)) requires that the claim be noted in all statements sent to the transferee or pledgee.

Subsection (7) (A.C.A. § 4-8-403(7)) deals with the situation in which an uncertificated security is already subject to as registered pledge when the issuer first learns of an adverse claim as to which it has a duty. In that event, the registered

pledgee who became such without notice of the claim may be a bona fide purchaser with the right to transfer the security free of the claim. That right cannot be curtailed by the claim of a third party (including the registered owner) unless legal process embodying the claim expressly deals with the pledgee's interest. There is obviously no curtailment of the pledgee's right when the claim is asserted by the pledgee himself. It should be curtailed if the pledgee's right to obtain registration of transfer is called into question by a controlling instrument which the issuer elects to require before acting on the pledgee's request. Since the transfer to the registered owner is the equivalent of a release of the pledge, such a transfer does not terminate the issuer's duty as to the claim.

#### *Cross References:*

Sections 1-203 (A.C.A. § 4-1-203), 8-304 (A.C.A. § 4-8-304), 8-401 (A.C.A. § 4-8-401), 8-402 (A.C.A. § 4-8-402), 8-404 (A.C.A. § 4-8-404), 8-405 (A.C.A. § 4-8-405) and 8-408 (A.C.A. § 4-8-408).

#### *Definitional Cross References:*

"Adverse Claim". Section 8-302 (A.C.A. § 4-8-302).

"Appropriate Person". Section 8-308 (A.C.A. § 4-8-308).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Indorsement". Section 8-308 (A.C.A. § 4-8-308).

"Initial Transaction Statement". Section 8-408 (A.C.A. § 4-8-408).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Notification". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Written". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1985, No. 514, § 3(8-403), to incorporate the 1977 changes to this Uniform Commercial Code section.



**Comment to § 8-404 (A.C.A. § 4-8-404)\***

*Prior Uniform Statutory Provision:*  
None.

*Purposes:*

1. This section states the basic exonerative policy of this Article (Chapter) where there is no duty to inquire into adverse claims and the certificated security is appropriately indorsed or the issuer receives an instruction from an appropriate person.

Note that under subsection (1)(a) (A.C.A. § 4-8-404(1)(a)) exoneration depends on whether or not the necessary indorsements were in fact on or with the security. The issuer cannot, for example, defend a suit based on its having registered a transfer on a forged indorsement on the ground that it received the assurances listed in Section 8-402 (A.C.A. § 4-8-402) and was under no duty to go further. It has that option under Section 8-402(4) (A.C.A. § 4-8-402(4)).

Note, however, that this Act excludes from the category of "unauthorized indorsement" (Section 8-311 (A.C.A. § 4-8-311)) certain situations that might have been included in that category under prior law — e.g., where there has been a change of circumstances subsequent to the signature (subsection (10) of Section 8-308 (A.C.A. § 4-8-308(10))), and where the signature is that of a fiduciary who has failed to obtain court approval of the transfer (subsection (11) of Section 8-308 (A.C.A. § 4-8-308(11))). Similarly when an issuer acts on the assumption permitted by section (3)(a) of Section 8-403 (A.C.A. § 4-8-403(3)(a)), that a fiduciary registered owner continues to act as such, the "necessary indorsement" under subsection (1)(a) of this section (A.C.A. § 4-8-404(1)(a)) is that of the registered owner under Section 8-308(8)(a) (A.C.A. § 4-8-308(8)(a)), even though a successor has in fact been appointed. In these and other cases, where the question is one affecting only the rightfulness of the transfer, the issuer need only establish that it had no duty under Section 8-403 (A.C.A. § 4-8-403) to inquire into adverse claims or that it has discharged any such duty.

2. The registered owner's right to receive a new security where the issuer has wrongfully registered a transfer is established, but the cases have also recognized

his right to elect between an equitable action to compel issue of a new security and an action for damages. Cf. *Casper v. Kalt-Zimmers Mfg. Co.*, 159 Wis. 517, 149 N.W. 754 (1914). Such election of remedies is no longer available. The true owner of a certificated security is now required to take a new security except where an over-issue would result and a similar security is not reasonably available for purchase. See Section 8-104 (A.C.A. § 4-8-104). The true owner of an uncertificated security is entitled and required to take restoration of the records to their proper state, with a similar exception for overissue.

Nothing in subsections (2) and (3) (A.C.A. § 4-8-404(2) and (3)) is intended to deny the owner the right to choose the form of his security whenever the issuer maintains securities of the same issue in both certificated and uncertificated form (Section 8-407 (A.C.A. § 4-8-407)).

*Cross References:*

Point 1: Sections 8-308 (A.C.A. § 4-8-308), 8-402 (A.C.A. § 4-8-402) and 8-403 (A.C.A. § 4-8-403).

Point 2: Sections 8-104 (A.C.A. § 4-8-104), 8-405 (A.C.A. § 4-8-405) and 8-407 (A.C.A. § 4-8-407).

*Definitional Cross References:*

"Adverse Claim". Section 8-302 (A.C.A. § 4-8-302).

"Appropriate Person". Section 8-308 (A.C.A. § 4-8-308).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Deliver". Section 1-201 (A.C.A. § 4-1-201).

"Indorsement". Section 8-308 (A.C.A. § 4-8-308).

"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Overissue". Section 8-104 (A.C.A. § 4-8-104).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

\*This section was amended by Acts 1985, No. 514, § 3 (8-404), to incorporate the

1977 changes to this Uniform Commercial Code section.

### Comment to § 8-405 (A.C.A. § 4-8-405)\*

#### *Prior Uniform Statutory Provision:*

Section 17, Uniform Stock Transfer Act.

#### *Purposes:*

1. By failing to notify the issuer within a reasonable time after he knows or has reason to know of the loss or theft of his certificated security, the owner is estopped from asserting the ineffectiveness of a forged or unauthorized indorsement and the wrongfulness of the registration of the transfer. Compare Section 8-311 (A.C.A. § 4-8-311). If the lost security was indorsed by the owner, then the registration of the transfer was not wrongful under Section 8-404 (A.C.A. § 4-8-404) unless notice had been given to the issuer.

2. The long standing corporate practice of voluntarily issuing new certificated securities to replace lost, destroyed or stolen ones is now incorporated into law. Where reasonable requirements are satisfied and a sufficient indemnity bond supplied, a court order is no longer necessary but, of course, the court may compel a recalcitrant issuer to take action.

Subsection (2) (A.C.A. § 4-8-405(2)) gives the issuer the alternative of issuing an uncertificated security rather than a new certificated security. This alternative will exist only when the particular issue is partly certificated and partly uncertificated; and as a practical matter the ultimate choice will belong to the owner (Section 8-407 (A.C.A. § 4-8-407). Compare Section 8-104 (A.C.A. § 4-8-104) and its Comment.

3. Where an "original" certificated security has reached the hands of a bona fide purchaser, the registered owner — who was in the best position to prevent the loss, destruction or theft of his security — is now deprived of the new security issued to him as a replacement. If the security is certificated, the issuer has a right to recover it; and if the security is uncertificated, the issuer may simply cancel the registration. This changes the prior law under which the original security was ineffective after the issue of a replacement except insofar as it might

represent an action for damages in the hands of a bona fide purchaser. *Keller v. Eureka Brick Mach. Mfg. Co.*, 43 Mo.App. 84, 11 L.R.A. 472 (1890). Where both the original and the new security have reached bona fide purchasers the issuer is now required to honor both securities unless an overissue would result and the security is not reasonably available for purchase. See Section 8-104 (A.C.A. § 4-8-104). In the latter case alone, the bona fide purchaser of the original security is relegated to an action for damages. In either case, the issuer itself may recover on the indemnity bond.

#### *Cross References:*

Sections 8-104 (A.C.A. § 4-8-104), 8-311 (A.C.A. § 4-8-311), 8-312 (A.C.A. § 4-8-312), 8-402 (A.C.A. § 4-8-402), 8-403 (A.C.A. § 4-8-403), 8-404 (A.C.A. § 4-8-404) and 8-407 (A.C.A. § 4-8-407).

#### *Definitional Cross References:*

"Bona Fide Purchaser". Section 8-302 (A.C.A. § 4-8-302).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Notify". Section 1-201 (A.C.A. § 4-1-201).

"Overissue". Section 8-104 (A.C.A. § 4-8-104).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Reasonable Time". Section 1-204 (A.C.A. § 4-1-204).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

\*This section was amended by Acts 1985, No. 318, § 3 (8-405), to incorporate the 1977 changes to this Uniform Commercial Code section.



**Comment to § 8-406 (A.C.A. § 4-8-406)\****Prior Uniform Statutory Provision:*

None.

*Purposes:*

1. Transfer agents, registrars and the like are here expressly held liable to both the issuer and the owner for wrongful refusal to register a transfer as well as wrongful registration of a transfer in any case within the scope of their respective functions where the issuer would itself be liable. Those cases which have regarded these parties solely as agents of the issuer and have therefore refused to recognize their liability to the owner for mere non-feasance, i.e., refusal to register a transfer, are now rejected. *Hulse v. Consolidated Quicksilver Mining Corp.*, 65 Idaho 768, 154 P.2d 149 (1944); *Nicholson v. Morgan*, 119 Misc. 309, 196 N.Y.Supp. 147 (1922); *Lewis v. Hargadine-McKittrick Dry Goods Co.*, 305 Mo. 396, 274 S.W. 1041 (1924).

2. The practice frequently followed by authenticating trustees of issuing certificates of indebtedness rather than authenticating duplicate certificates where securities have been lost or stolen now becomes obsolete in view of the provisions of the preceding section of this Article (Chapter), which makes express provision for the issue of substitute securities. It can no longer be considered a breach of trust or lack of due diligence to trustees to authenticate new securities (or initial transaction statements). Cf. *Switzerland General Ins. Co. v. N.Y.C. & H.R.R. Co.*, 152 App.Div. 70, 136 N.Y.S. 726 (1912).

3. "Good faith and due diligence" require the use of reasonable care and the observance of "reasonable" commercial standards, and preclude arbitrary, capricious, over-cautious and super-technical objections and requirements. See *Powers v. Universal Film Mfg. Co.*, 162 App.Div. 806, 148 N.Y.S. 114 (1914). Compliance

with the provisions of this Article (Chapter) as to the documents which an issuer may properly require before registering a transfer in cases where there has been no notice of adverse claims (Section 8-402 (A.C.A. § 4-8-402)) constitutes due diligence on the part of these agents and insisting upon more would incur liability for wrongful refusal to register a transfer.

*Cross References:*

Point 3: Sections 8-401 (A.C.A. § 4-8-401), 8-402 (A.C.A. § 4-8-402), 8-403 (A.C.A. § 4-8-403) and 8-404 (A.C.A. § 4-8-404). See Sections 1-201 (A.C.A. § 4-1-201), 8-207 (A.C.A. § 4-8-207), 8-208 (A.C.A. § 4-8-208), 8-312 (A.C.A. § 4-8-312), 8-401 (A.C.A. § 4-8-401), 8-402 (A.C.A. § 4-8-402), 8-403 (A.C.A. § 4-8-403), 8-405 (A.C.A. § 4-8-405), 8-407 (A.C.A. § 4-8-407) and 8-408 (A.C.A. § 4-8-408).

*Definitional Cross References:*

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Good Faith". Section 1-201 (A.C.A. § 4-1-201).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

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\*This section was amended by Acts 1985, No. 514, § 3 (8-406), to incorporate the 1977 changes to this Uniform Commercial Code section.

**Comment to § 8-407 (A.C.A. § 4-8-407)***Prior Uniform Statutory Provision:*

None.

*Purposes:*

This section deals with the right of the holder of a certificated security to exchange it for an equivalent uncertificated

security and the right of the registered owner or registered pledgee of an uncertificated security to obtain a certificated security in exchange for it. This section is applicable only in those situations where both certificated and uncertificated securities exist within the

same issue and either form is available to the particular owner. Subsection (1) (A.C.A. § 4-8-407(1)) so limits its applicability.

Neither this nor any other section of this Article (Chapter) is intended to mandate the establishment or continuance of a dual system of registration. It is contemplated that some issuers may provide for both forms of securities on a more or less indefinite basis. Issuers of existing issues which are necessarily wholly certificated may make uncertificated securities available with the intention to phase out the certificated securities over a period of time. Some issuers, if permitted by relevant law, may restrict the availability of uncertificated securities to particular categories of owners, e.g., brokers, banks and institutions.

Subsection (2) (A.C.A. § 4-8-407(2)) provides the mechanism for the holder of a certificated security to surrender it to the issuer and have an equivalent uncertificated security issued in exchange. Subsection (3) (A.C.A. § 4-8-407(3)) provides an analogous mechanism for the registered owner of an unencumbered uncertificated security or the registered pledgee of an otherwise unencumbered uncertificated security to obtain equivalent certificated securities from the issuer. Since Section 8-403 (A.C.A. § 4-8-403) treats adverse claims with respect to certificated securities differently from adverse claims with respect to uncertificated securities, subsection (2) (A.C.A. § 4-8-407(2)) requires the issuer to honor the request only if it has no duty as to adverse claims. If it honored the request despite the presence of such a duty, the adverse claimant's right to block transfer might be modified. For example, if the issuer of a certificated security had received written notice from the claimant, it would be under a duty to inquire and to delay registration of transfer pending the results of the inquiry. However, if it issued an uncertificated security in place of the certificate, then it would no longer be under a

duty (Section 8-403(4)(b) (A.C.A. § 4-8-403(4)(b))) and would register transfer to a bona fide purchaser without including any notation of the claim (Section 8-403(5) (A.C.A. § 4-8-403(5))).

On the other hand, if the issuer is under a duty as to adverse claims with respect to an uncertificated security it will also be under a similar duty with respect to a certificated security issued to represent the same interest. Compare subsections (1) and (4) of Section 8-403 (A.C.A. § 4-8-403(1) and (4)). Potential purchasers will be unable to purchase free of the claim, since they will be given notice through notation on the certificate. See Sections 8-304 (A.C.A. § 4-8-304), 8-202 (A.C.A. § 4-8-202) and 1-201(25) (A.C.A. § 4-1-201(25)).

#### *Cross References:*

Sections 8-104 (A.C.A. § 4-8-104), 8-403 (A.C.A. § 4-8-403) and 8-405 (A.C.A. § 4-8-405).

#### *Definitional Cross References:*

"Adverse Claim". Section 8-302 (A.C.A. § 4-8-302).

"Appropriate Person". Section 8-308 (A.C.A. § 4-8-308).

"Certificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Conspicuous". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Indorsement". Section 8-308 (A.C.A. § 4-8-308).

"Instruction". Section 8-308 (A.C.A. § 4-8-308).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Written". Section 1-201 (A.C.A. § 4-1-201).



### Comment to § 8-408 (A.C.A. § 4-8-408)

#### *Prior Uniform Statutory Provision:*

None.

#### *Purposes:*

1. This section obliges the issuer of uncertificated securities to send certain statements. The required statements are of two types. Transaction statements, required by subsections (1), (2), (3) and (5) (A.C.A. § 4-8-408(1), (2), (3) and (5)) are analogous to debit and credit advices and the periodic statements can be reconciled from them. Periodic statements, required by subsections (6) and (7) (A.C.A. § 4-8-408(6) and (7)) are analogous to bank statements and will advise owners and pledgees of their positions at given points in time.

The transaction statements, which are mandated upon the registration of transfer, pledge or release, must be sent within two days after the relevant registration, but it is contemplated that such statements will be prepared virtually simultaneously with the actual registration and sent immediately thereafter. They are intended to serve two functions. They are notice to the transferor — (the owner in the case of transfer or pledge, the pledgee in the case of release from pledge, and both the owner and the pledgee in the case of transfer subject to a pledge, transfer of the pledge interest alone or simultaneous transfer and release from pledge) — that his interest has been altered. In the event of fraudulent, unauthorized or otherwise improper registration, the transaction statement will serve as notice that timely action should be taken.

More importantly, these statements are notice to the transferee (new owner in the case of a transfer, pledgee in the case of a pledge, present owner in the case of a release) that the increase of his interest has, in fact, been registered. Furthermore, since all statements except those required by subsection (5) (A.C.A. § 4-8-408(5)) must include a notation of defects or an express statement that there are none, these statements will give the transferee the assurance equivalent to that afforded by a "clean" certificated security and create an estoppel against the issuer. Since registration is the critical step in the transfer of rights, the issuer's transaction statement should include, and the pur-

chaser who receives the statement should be charged with notice of, only those claims, liens and restrictions existing at the time of registration. Compare Section 8-304(2) (A.C.A. § 4-8-304(2)).

It is contemplated that transferees will and should be able to rely on these statements and, in many cases, will not part with their consideration until they receive them. To ensure that the statements will have the desired effect of establishing rights for the transferee against the issuer, subsection (4) (A.C.A. § 4-8-408(4)) requires that the copy of each transaction statement sent to the transferee, called an "initial transaction statement," be signed. Note that Section 1-201(39) (A.C.A. § 4-1-201(39)) does not require a manual signature for compliance with this requirement. Compare also Sections 8-103(b) (A.C.A. § 4-8-103(b)), 8-105(3)(d) (A.C.A. § 4-8-105(3)(d)), 8-202 (A.C.A. § 4-8-202), 8-204(b) (A.C.A. § 4-8-204(b)), 8-205 (A.C.A. § 4-8-205), 8-206 (A.C.A. § 4-8-206), 8-208 (A.C.A. § 4-8-208), 8-304 (A.C.A. § 4-8-304), 8-311 (A.C.A. § 4-8-311), 8-319 (A.C.A. § 4-8-319) and 8-403 (A.C.A. § 4-8-403) for the effects of initial transaction statements.

2. Whenever the issuer registers a transfer of the pledge interest alone, subsections (2) and (3) (A.C.A. § 4-8-408(2) and (3)) read together require the issuer to send transaction statements to both the registered owner and the former registered pledgee as well as to the new registered pledgee. Compare Section 8-207(4) (A.C.A. § 4-8-207(4)) and its Comment 1.

3. The frequency of one year, with which periodic statements must be sent to owners and pledgees, is intended to be a minimum requirement for all issuers, including closely held corporations. Owners and pledgees are entitled to request additional statements of position at any time. It is contemplated, however, that publicly held issuers will adopt the practice of sending quarterly statements conforming to the common practice of sending quarterly reports and dividend checks. For those that do, subsection (8) (A.C.A. § 4-8-408(8)) eliminates the obligation to furnish additional statements of position on request unless the issuer is reimbursed for the additional cost.

4. Subsection (9) (A.C.A. § 4-8-408(9)) requires that a conspicuous legend be borne by each statement as a protection against unjustified reliance on statements of uncertificated securities by persons who might deal with them. Except for this requirement and the requirement of subsection (4) (A.C.A. § 4-8-408(4)) that the words "Initial Transaction Statement" be included, the form of the statements required by this section is not prescribed. Perhaps the forms now used by the transfer agents of mutual funds to confirm acquisitions, dispositions, reinvestment of dividends, periodic liquidations and statements of position will serve as a model.

*Cross References:*

Point 1: Sections 8-103 (A.C.A. § 4-8-103), 8-105 (A.C.A. § 4-8-105), 8-202 (A.C.A. § 4-8-202), 8-204 (A.C.A. § 4-8-204), 8-205 (A.C.A. § 4-8-205), 8-206 (A.C.A. § 4-8-206), 8-208 (A.C.A. § 4-8-208) and 8-304 (A.C.A. § 4-8-304).

Point 2: Section 8-207 (A.C.A. § 4-8-207).

*Definitional Cross References:*

"Adverse Claim". Section 8-302 (A.C.A. § 4-8-302).

"Conspicuous". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Issuer". Section 8-201 (A.C.A. § 4-8-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Uncertificated Security". Section 8-102 (A.C.A. § 4-8-102).

"Written". Section 1-201 (A.C.A. § 4-1-201).



## ARTICLE 9

## (A.C.A. 4-9-101 ET SEQ.)

**1972 Official Comment to § 9-101 (A.C.A. § 4-9-101)**

This Article (Chapter) sets out a comprehensive scheme for the regulation of security interests in personal property and fixtures. It supersedes prior legislation dealing with such security devices as chattel mortgages, conditional sales, trust receipts, factor's liens and assignments of accounts receivable (see Note to Section 9-102 (A.C.A. § 4-9-102)).

Consumer installment sales and consumer loans present special problems of a nature which makes special regulation of them inappropriate in a general commercial codification. Many states now regulate such loans and sales under small loan acts, retail installment selling acts and the like. The National Conference of Commissioners on Uniform State Laws has proposed a Uniform Consumer Credit Code dealing with this subject. While this Article (Chapter) applies generally to security interests in consumer goods, it is not designed to supersede such regulatory legislation (see Notes to Sections 9-102 (A.C.A. § 4-9-102) and 9-203 (A.C.A. § 4-9-203)). Nor is this Article (Chapter) designed as a substitute for small loan acts or retail installment selling acts in any state which does not presently have such legislation.

Pre-Code law recognized a wide variety of security devices, which came into use at various times to make possible different types of secured financing. Differences between one device and another persisted, in formal requisites, in the secured party's rights against the debtor and third parties, in the debtor's rights against the secured party, and in filing requirements, although many of those differences no longer served any useful function. Thus an unfiled chattel mortgage was by the law of many states "void" against creditors generally; a conditional sale, often available as a substitute for the chattel mortgage, was in some states valid against all creditors without filing, and in states where filing is required was, if unfiled, void only against lien creditors. The recognition of so many separate security devices had the result that half a dozen filing systems covering chattel security

devices might be maintained within a state, some on a county basis, others on a state-wide basis, each of which had to be separately checked to determine a debtor's status.

Nevertheless, despite the great number of security devices there remained gaps in the structure. In many states, for example, a security interest could not be taken in inventory or a stock in trade although there was a real need for such financing. It was often baffling to try to maintain a technically valid security interest when financing a manufacturing process, where the collateral starts out as raw materials, becomes work in process and ends as finished goods. Furthermore, it was by no means clear, even to specialists, how under pre-Code law a security interest might be taken in many kinds of intangible property — such as television or motion picture rights — which have come to be an important source of commercial collateral.

While the chattel mortgage was adaptable for use in almost any situation where goods are collateral, there were limitations, sometimes highly technical, on the use of other devices, such as the conditional sale and particularly the trust receipt. The cases are many in which a security transaction described by the parties as a conditional sale or a trust receipt was later determined by a court to be something else, usually a chattel mortgage. The consequence of such a determination was typically to void the security interest against creditors because the security agreement was not filed as a chattel mortgage (even though it may have been filed as a conditional sale or a trust receipt). The already mentioned difficulty of financing on the security of inventory was got around to some extent by the device known as "field warehousing" as well as by the use of the trust receipt. After 1940 a number of states generally authorized inventory financing by enacting statutes, similar although not uniform, known as "factor's lien" acts. Also after 1940 the increasingly important business of lending against accounts receivable inspired

new statutes in that field in more than thirty states.

The growing complexity of financing transactions forced legislatures to keep piling new statutory provisions on top of our inadequate and already sufficiently complicated nineteenth-century structure of security law. The results of this continuing development were increasing costs to both parties and increasing uncertainty as to their rights and the rights of third parties dealing with them.

The aim of this Article (Chapter) is to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty.

Under this Article (Chapter) the traditional distinctions among security devices, based largely on form, are not retained; the Article (Chapter) applies to all transactions intended to create security interests in personal property and fixtures, and the single term "security interest" substitutes for the variety of descriptive terms which had grown up at common law and under a hundred-year accretion of statutes. This does not mean that the old forms may not be used, and Section 9-102(2) (A.C.A. § 4-9-102(2)) makes it clear that they may be.

This Article (Chapter) does not determine whether "title" to collateral is in the secured party or in the debtor and adopts neither a "title theory" nor a "lien theory" of security interests. Rights, obligations and remedies under the Article (Chapter) do not depend on the location of title (Section 9-202 (A.C.A. § 4-9-202)). The location of title may become important for other purposes — as, for example, in determining the incidence of taxation — and in such a case the parties are left free to contract as they will. In this connection the use of a form which has traditionally been regarded as determinative of title (e.g., the conditional sale) could reasonably be regarded as evidencing the parties' intention with respect to title to the collateral.

Under the Article (Chapter) distinctions based on form (except as between pledge and non-possessory interests) are no longer controlling. For some purposes there are distinctions based on the type of property which constitutes the collateral — industrial and commercial equipment, business inventory, farm products, consumer goods, accounts receivable, documents of title and other intangibles — and, where appropriate, the Article (Chapter) states special rules applicable to financing transactions involving a particular type of property. Despite the statutory simplification a greater degree of flexibility in the financing transaction is allowed than is possible under existing law.

The scheme of the Article (Chapter) is to make distinctions, where distinctions are necessary, along functional rather than formal lines.

This has made possible a radical simplification in the formal requisites for creation of a security interest.

A more rational filing system replaces the present system of different files for each security device which is subject to filing requirements. Thus not only is the information contained in the files made more accessible but the cost of procuring credit information, and, incidentally, of maintaining the files, is greatly reduced.

The Article's (Chapter's) flexibility and simplified formalities should make it possible for new forms of secured financing, as they develop, to fit comfortably under its provisions, thus avoiding the necessity, so apparent in recent years, of year by year passing new statutes and tinkering with the old ones to allow legitimate business transactions to go forward.

The rules set out in this Article (Chapter) are principally concerned with the limits of the secured party's protection against purchasers from and creditors of the debtor. Except for procedure on default, freedom of contract prevails between the immediate parties to the security transaction.



**1972 Official Comment to § 9-102 (A.C.A. § 4-9-102)\***

*Prior Uniform Statutory Provision:* None.

*Purposes:*

The main purpose of this Section is to bring all consensual security interests in personal property and fixtures under this Article (Chapter), except for certain types of transactions excluded by Section 9-104 (A.C.A. § 4-9-104). In addition certain sales of accounts and chattel paper are brought within this Article (Chapter) to avoid difficult problems of distinguishing between transactions intended for security and those not so intended. As to security interests in fixtures created under the law applicable to real estate, see Section 9-313(1) (A.C.A. § 4-9-313(1)).

1. Except for sales of accounts and chattel paper, the principal test whether a transaction comes under this Article (Chapter) is: is the transaction intended to have effect as security? For example, Section 9-104 (A.C.A. § 4-9-104) excludes certain transactions where the security interest (such as an artisan's lien) arises under statute or common law by reason of status and not by consent of the parties. Transactions in the form of consignments or leases are subject to this Article (Chapter) if the understanding of the parties or the effect of the arrangement shows that a security interest was intended. (As to consignments the provisions of Sections 2-326 (A.C.A. § 4-2-326), 9-114 (A.C.A. § 4-9-114) and 9-408 (A.C.A. § 4-9-408) should be consulted.) When it is found that a security interest as defined in Section 1-201(37) (A.C.A. § 4-1-201(37)) was intended, this Article (Chapter) applies regardless of the form of the transaction or the name by which the parties may have christened it. The list of traditional security devices in subsection (2) (A.C.A. § 4-9-102(2)) is illustrative only; other old devices, as well as any new ones which the ingenuity of lawyers may invent, are included, so long as the requisite intent is found. The controlling definition is that contained in subsection (1) (A.C.A. § 4-9-102(1)).

The Article (Chapter) does not in terms abolish existing security devices. The conditional sale or bailment-lease, for example, is not prohibited; but even though it is used, the rules of this Article (Chapter) govern.

2. If an obligation is to repay money lent and is not part of chattel paper, it is either an instrument or a general intangible. A sale of an instrument or general intangible is not within this Article (Chapter), but a transfer intended to have effect as security for an obligation of the transferor is covered by subsection 1(a) (A.C.A. § 4-9-102(1)(a)). In either case the nature of the transaction is not affected by the fact that collateral is transferred with the instrument or general intangible. Such a transfer is treated as a transfer by operation of law, whether or not it is articulated in the agreement.

An assignment of accounts or chattel paper as security for an obligation is covered by subsection (1)(a) (A.C.A. § 4-9-102(1)(a)). Commercial financing on the basis of accounts and chattel paper is often so conducted that the distinction between a security transfer and a sale is blurred, and a sale of such property is therefore covered by subsection (1)(b) (A.C.A. § 4-9-102(1)(b)) whether intended for security or not, unless excluded by Section 9-104 (A.C.A. § 4-9-104). The buyer then is treated as a secured party, and his interest as a security interest. See Sections 9-105(1)(m) (A.C.A. § 4-9-105(1)(m)), 1-201(37) (A.C.A. § 4-1-201(37)). Certain sales which have nothing to do with commercial financing transactions are excluded by Section 9-104(f) (A.C.A. § 4-9-104(f)); compare *Spurlin v. Sloan*, 368 S.W.2d 314 (Ky.1963). See also Section 9-302(1)(e) (A.C.A. § 4-9-302(1)(e)), exempting from filing casual or isolated assignments, and Section 9-302(2) (A.C.A. § 4-9-302(2)), preserving the perfected status of a security interest against the original debtor when a secured party assigns his interest.

3. In general, problems of choice of law in this Article (Chapter) as to the validity of security agreements are governed by Section 1-105 (A.C.A. § 4-1-105). Problems of choice of law as to perfection of security interests and the effect of perfection or non-perfection thereof, including rules requiring reperfecting, are governed by Section 9-103 (A.C.A. § 4-9-103).

4. An illustration of subsection (3) (A.C.A. § 4-9-103(3)) is as follows:

The owner of Blackacre borrows

\$10,000 from his neighbor, and secures his note by a mortgage on Blackacre. This Article (Chapter) is not applicable to the creation of the real estate mortgage. Nor is it applicable to a sale of the note by the mortgagee, even though the mortgage continues to secure the note. However, when the mortgagee pledges the note to secure his own obligation to X, this Article (Chapter) applies to the security interest thus created, which is a security interest in an instrument even though the instrument is secured by a real estate mortgage. This Article leaves to other law the question of the effect on rights under the

mortgage of delivery or non-delivery of the mortgage or of recording or nonrecording of an assignment of the mortgagee's interest. See Section 9-104(j) (A.C.A. § 4-9-104(j)). But under Section 3-304(5) (A.C.A. § 4-3-304(5)) recording of the assignment does not of itself prevent X from holding the note in due course.

5. While most sections of this Article (Chapter) apply to a security interest without regard to the nature of the collateral or its use, some sections state special rules with reference to particular types of collateral. An index of sections where such special rules are stated follows:

## ACCOUNTS

### Section

9-102(1)(b) (A.C.A. 4-9-102(1)(b))	Sale of accounts subject to Article (Chapter)
9-103(1) (A.C.A. 4-9-103(1))	When Article (Chapter) applies; conflict of laws rules
9-104(f) (A.C.A. 4-9-104(f))	Certain sales of accounts excluded from Article
9-106 (A.C.A. 4-9-106)	Definitions
9-205 (A.C.A. 4-9-205)	Permissible for debtor to make collections
9-206(1) (A.C.A. 4-9-206(1))	Agreement not to assert defenses against assignee
9-301(1)(d) (A.C.A. 4-9-301(1)(d))	Unperfected security interest subordinate to certain transferees
9-302(1)(e) (A.C.A. 4-9-302(1)(e))	What assignments need not be filed
9-306(5) (A.C.A. 4-9-306(5))	Rule when goods whose sale gave rise to an account return to seller's possession
9-318(1) (A.C.A. 4-9-318(1))	Rights of assignee subject to defenses
9-318(2) (A.C.A. 4-9-318(2))	Modification of contract after assignment of contract right
9-318(3) (A.C.A. 4-9-318(3))	When account debtor may pay assignor
9-318(4) (A.C.A. 4-9-318(4))	Term prohibiting assignment ineffective
9-401 (A.C.A. 4-9-401)	Place of filing
9-502 (A.C.A. 4-9-502)	Collection rights of secured party
9-504(2) (A.C.A. 4-9-504(2))	Rights on default where underlying transaction was sale of accounts or contract rights



## Section

## CHATTEL PAPER

9-102(1)(b) (A.C.A. 4-9-102(1)(b))	Sale subject to Article (Chapter)
9-104(f) (A.C.A. 4-9-104(f))	Certain sales excluded from Article (Chapter)
9-105(1)(b) (A.C.A. 4-9-105(1)(b))	Definition
9-205 (A.C.A. 4-9-205)	Permissible for debtor to make collections
9-206(1) (A.C.A. 4-9-206(1))	Agreement not to assert defenses against assignee
9-207(1) (A.C.A. 4-9-207(1))	Duty of secured party in possession to preserve rights against prior parties
9-301(1)(c) (A.C.A. 4-9-301(1)(c))	Unperfected security interest subordinate to certain transferees
9-304(1) (A.C.A. 4-9-304(1))	Perfection by filing
9-305 (A.C.A. 4-9-305)	When possession by secured party perfects security interest
9-306(5) (A.C.A. 4-9-306(5))	Rule when goods whose sale results in chattel paper return to seller's possession
9-308 (A.C.A. 4-9-308)	When purchasers of chattel paper have priority over security interest
9-318(1) (A.C.A. 4-9-318(1))	Rights of assignee subject to defenses
9-318(3) (A.C.A. 4-9-318(3))	When account debtor may pay assignor
9-502 (A.C.A. 4-9-502)	Collection rights of secured party
9-504(2) (A.C.A. 4-9-504(2))	Rights on default where underlying transaction was sale

## DOCUMENTS AND INSTRUMENTS

9-105(1)(e) (A.C.A. 4-9-105(1)(e))	Definition of document (and see § 1-201 (A.C.A. § 4-1-201)
9-105(1)(g) (A.C.A. 4-9-105(1)(g))	Definition of instrument
9-206(1) (A.C.A. 4-9-206(1))	Rule where buyer of goods signs both negotiable instrument and security agreement
9-207(1) (A.C.A. 4-9-207(1))	Duty of secured party in possession of instrument to preserve rights against prior parties
9-301(1)(c) (A.C.A. 4-9-301(1)(c))	Unperfected security interest subordinate to certain transferees
9-302(1)(b) and (f) (A.C.A. 4-9-302(1)(b) and (f))	What interests need not be filed
9-304(1)	How security interest can be perfected

## Section

(A.C.A. 4-9-304(1))	
9-304(2, 3)	Perfection of security interest in goods in possession of issuer of negotiable document or of other bailee
(A.C.A. 4-9-304(2, 3))	
9-304(4, 5)	Perfection of security interest in instruments or negotiable documents without filing or transfer of possession
(A.C.A. 4-9-304(4, 5))	
9-305	When possession by secured party perfects security interest
(A.C.A. 4-9-305)	
9-308	When purchasers of instruments have priority over security interest
(A.C.A. 4-9-308)	
9-309	When purchasers of negotiable instruments or negotiable documents have priority over security interest
(A.C.A. 4-9-309)	
9-501(1)	Rights on default where collateral is documents
(A.C.A. 4-9-501(1))	
9-502	Collection rights of secured party
(A.C.A. 4-9-502)	

## GENERAL INTANGIBLES

9-103(2)	When Article (Chapter) applies; conflict of laws rules
(A.C.A. 4-9-103(2))	
9-105	Obligor is "account debtor"
(A.C.A. 4-9-105)	
9-106	Definition
(A.C.A. 4-9-106)	
9-301(1)(d)	Unperfected security interest subordinate to certain transferees
(A.C.A. 4-9-301(1)(d))	
9-318(1)	Rights of assignee subject to defenses
(A.C.A. 4-9-318(1))	
9-318(3)	When account debtor may pay assignor
(A.C.A. 4-9-318(3))	
9-502	Collection rights of secured party
(A.C.A. 4-9-502)	

## GOODS

(See also Consumer Goods, Equipment, Farm Products, Inventory)

9-103	When Article (Chapter) applies with regard to goods of a type normally used in more than one jurisdiction; goods covered by certificate of title; conflict of laws rules
(A.C.A. 4-9-103)	
9-105(1)(h)	Definition
(A.C.A. 4-9-105(1)(h))	
9-109	Classification of goods as consumer goods, equipment, farm products and inventory
(A.C.A. 4-9-109)	
9-203	Formal requisites of security agreement covering certain types of goods (crops or timber)
(A.C.A. 4-9-203)	
9-204	Validity of after-acquired property clause covering certain types of goods (crops, consumer goods)
(A.C.A. 4-9-204)	
9-205	Permissible for debtor to accept returned goods
(A.C.A. 4-9-205)	



## Section

9-206(2) (A.C.A. 4-9-206(2))	When security agreement can limit or modify warranties on sale
9-301(1)(c) (A.C.A. 4-9-301(1)(c))	Unperfected security interest subordinate to certain transferees
9-304(2, 3) (A.C.A. 4-9-304(2, 3))	Perfection of security interest in goods in possession of issuer of negotiable document or of other bailee
9-304(5) (A.C.A. 4-9-304(5))	Perfection of security interest without filing or transfer of possession where goods in possession of certain bailees
9-305 (A.C.A. 4-9-305)	When possession by secured party perfects security interest
9-306(5) (A.C.A. 4-9-306(5))	Rule when goods whose sale gave rise to account or chattel paper return to seller's possession
9-307 (A.C.A. 4-9-307)	When buyers of goods from debtor take free of security interest
9-313 (A.C.A. 4-9-313)	Goods which are or become fixtures
9-314 (A.C.A. 4-9-314)	Goods affixed to other goods
9-315 (A.C.A. 4-9-315)	Goods commingled in a product
9-401(1) (A.C.A. 4-9-401(1))	Place of filing for fixtures
9-402 (A.C.A. 4-9-402)	Form of financing statement covering fixtures
9-504(1) (A.C.A. 4-9-504(1))	Sale of goods by secured party after default subject to Article 2 (Chapter 2) (Sales)

## CONSUMER GOODS

9-109(1) (A.C.A. 4-9-109(1))	Definition
9-203(2) (A.C.A. 4-9-203(2))	Transaction, although subject to this Article (Chapter), may also be subject to certain regulatory statutes
9-204(2) (A.C.A. 4-9-204(2))	Validity of after-acquired property clause
9-206(1) (A.C.A. 4-9-206(1))	Buyer's agreement not to assert defenses against an assignee subject to statute or decision which establishes rule for buyers of consumer goods
9-302(1)(d) (A.C.A. 4-9-302(1)(d))	When filing not required
9-307(2) (A.C.A. 4-9-307(2))	When buyers from debtor take free of security interest
9-401(1)(a) (A.C.A. 4-9-401(1)(a))	Place of filing
9-505(1) (A.C.A. 4-9-505(1))	Secured party's duty to dispose of repossessed consumer goods
9-507(1) (A.C.A. 4-9-507(1))	Secured party's liability for improper disposition of consumer goods after default

## Section

## EQUIPMENT

9-103(2) (A.C.A. 4-9-103(2))	When Article (Chapter) applies with regard to certain types of equipment normally used in more than one jurisdiction; conflict of laws rules
9-109(2) (A.C.A. 4-9-109(2))	Definition
9-302(1)(c) (A.C.A. 4-9-302(1)(c))	When filing not required to perfect security interest in certain farm equipment
9-307(2) (A.C.A. 4-9-307(2))	When buyers of certain farm equipment from debtor take free of security interest
9-401(1) (A.C.A. 4-9-401(1))	Place of filing for equipment used in farming operation
9-503 (A.C.A. 4-9-503)	Secured party's right after default to remove or to render equipment unusable

## FARM PRODUCTS

9-109(3) (A.C.A. 4-9-109(3))	Definition
9-203(1)(b) (A.C.A. 4-9-203(1)(b))	Formal requisites of security agreement covering crops
9-307 (A.C.A. 4-9-307)	When a buyer of farm products takes free of security interest
9-312(2) (A.C.A. 4-9-312(2))	Priority of secured party who gives new value to enable debtor to produce crops
9-401(1) (A.C.A. 4-9-401(1))	Place of filing
9-401(1) and (3) (A.C.A. 4-9-401(1) and (3))	Form of financing statement covering crops

## INVENTORY

9-103(3) (A.C.A. 4-9-103(3))	When Article (Chapter) applies with regard to certain types of inventory normally used in more than one jurisdiction; conflict of laws rules
9-109(4) (A.C.A. 4-9-109(4))	Definition
9-114 (A.C.A. 4-9-114)	Consigned goods
9-306(5) (A.C.A. 4-9-306(5))	Rule where goods whose sale gave rise to account or chattel paper return to seller's possession
9-307(1) (A.C.A. § 4-9-307(1))	When buyers from debtor take free of security interest
9-312(3) (A.C.A. 4-9-312(3))	
9-304(5) (A.C.A. 4-9-304(5))	When purchase money security interest takes priority over conflicting security interest
9-408 (A.C.A. 4-9-408)	Financing statements covering consigned or leased goods



*Cross References:*

Sections 9-103 (A.C.A. § 4-9-103) and 9-104 (A.C.A. § 4-9-104).

Point 1: Section 2-326 (A.C.A. § 4-2-326).

Point 2: Section 1-105 (A.C.A. § 4-1-105).

*Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 9-105 (A.C.A. § 4-9-105).

"General intangibles". Section 9-106 (A.C.A. § 4-9-106).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Instrument". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-102), to incorporate the 1972 changes to this Uniform Commercial Code section.

### 1972 Official Comment to § 9-103 (A.C.A. § 4-9-103)\*

*Prior Uniform Statutory Provision:* Paragraph 1(d) (A.C.A. § 4-9-103(1)(d)): Section 14, Uniform Conditional Sales Act.

*Purposes:*

1. The general rules on choice of law between the original parties in Section 1-105 (A.C.A. § 4-1-105) apply to this Article (Chapter). However, when conflicting claims to collateral arise, the question depends on perfection of security interests, and thus on the effect of perfection or non-perfection. These problems are dealt with in this section. The general rule (paragraph 1)(b) (A.C.A. § 4-9-103(1)(b))) is that these questions are governed by the law of the jurisdiction where the collateral is when the last event occurs on which is based the assertion that the security interest is perfected or unperfected. This event will frequently be the filing. If the last event is not filing and perfection is through filing, the filing required is in the jurisdiction where the collateral is when the last event occurs; prior filing in another jurisdiction is not effective and is not saved by the four-month rule discussed below, which applies only when the security interest was perfected in the jurisdiction from which the collateral was removed. If the security interest was perfected in one jurisdiction and then removed to another jurisdiction, maintenance of perfection in the latter jurisdiction or failure to do so is the "last event" to which the basic rule refers.

There are, however, exceptions to this basic rule:

2. If the parties to a transaction creating a purchase money security interest in goods understand when the security interest attaches that the collateral will be kept in another jurisdiction, the law of that jurisdiction governs perfection and the effect of perfection or non-perfection until 30 days after the debtor receives possession of the goods (paragraph 1)(c) (A.C.A. § 4-9-103(1)(c))). A filing in that jurisdiction perfects the security interest even before the goods are removed. The 30-day period is not a period of grace during which filing is unnecessary or has retroactive effect, but merely states the period during which the other jurisdiction is the place of filing. The effect of late filing is governed by other provisions, such as Sections 9-301 (A.C.A. § 4-9-301) and 9-312 (A.C.A. § 4-9-312).

3. If the goods reach that jurisdiction within the 30 days, the effectiveness of the filing in that jurisdiction continues without interruption. If the collateral is not kept in that jurisdiction before the end of the 30-day period, paragraph 1)(c) (A.C.A. § 4-9-103(1)(c)) ceases to be applicable and thereafter the law of the jurisdiction where the collateral is controls perfection. A failure of the collateral to reach the intended destination jurisdiction before the expiration of the 30-day period because of a conflicting claim or otherwise may cause disappointment of expectations that the law of the destination jurisdiction will govern continuously, and caution may dictate filing both in that jurisdiction and in the jurisdiction where the security interest attaches.

This section uses the concepts that goods are "kept" in a state or "brought" into a state, and related terms. These concepts imply a stopping place of a permanent nature in the state, not merely transit or storage intended to be transitory.

4.(a) Where the collateral is an automobile or other goods covered by a certificate of title issued by any state and the security interest is perfected by notation on the certificate of title, perfection is controlled by the certificate of title rather than by the law of the state wherein the security interest attached (subsection (2) (A.C.A. § 4-9-103(2))).

(b) It has long been hoped that "exclusive certificate of title laws" would provide a sure means of controlling property interests in goods like automobiles, which because of their nature cannot readily be controlled by local or statewide filing alone. In theory the certificate of title should control the property interests in the vehicle wherever the vehicle may be. However, two circumstances operate to prevent the perfect operation of the certificate of title device:

First, some states have never adopted certificate of title laws. This results in a problem in the issuance of a certificate of title when the vehicle moves from a non-certificate to a certificate state, because the certificate-issuing officer is in no position to conduct a complete search to ascertain the condition of the title in a state of origin which requires no filing or in which filing could be in any one or more of several localities. Also, it seems that when a vehicle moves from a certificate to a non-certificate state, the officers issuing a new registration for the vehicle are not always meticulous to notify secured parties shown on the certificate to give them a chance to perfect their security interests in the non-certificate state when a new registration is issued. Moreover, some vehicles like mobile homes are not always registered and title certificates are not always issued even in a state which may have certificate laws applicable thereto, because the certificate laws may apply only if the mobile homes use the highways. Registration plates of a mobile home having a certificate could be removed and there would be nothing visible to show that a certificate had ever been issued for it.

Second, various fraudulent devices based on allegations of loss of the certificate of title enable a dishonest person to obtain both an original and a duplicate of title; to have a security interest shown on only one thereof; and then to effect a transfer into a new state on the basis of the clean certificate, no matter how diligent the officers in the second state may be.

Given these practical problems, the choice of applicable rules of law after interstate removals of vehicles subject to certificate of title laws is most difficult. This Article (Chapter) provides the rules set forth below.

(c) The security interest perfected by notation on a certificate of title will be recognized without limit as to time; but, of course, perfection by this method ceases if the certificate of title is surrendered (paragraph (2)(b) (A.C.A. § 4-9-103(2)(b))). Since the secured party ordinarily holds the certificate, surrender thereof could not occur without his action in the matter in some respect. If the vehicle is reregistered in another jurisdiction while the secured party still holds the certificate, a danger of deception to third parties arises. The section provides that the certificate ceases to control after 4 months following removal if reregistration has occurred, but during the 4 months the secured party has the same protection for cases of interstate removal as is set forth in paragraph (1)(d) (A.C.A. § 4-9-103(1)(d)) of the section and Comment 7, subject to additional limitation if the reregistration also involves a new "clean" certificate of title in the removal jurisdiction and a non-professional buyer buys while that new certificate is outstanding. See paragraph (2)(d) (A.C.A. § 4-9-103(2)(d)) and Comment 4(e).

(d) If a vehicle not described in the preceding paragraph (i.e., not covered by a certificate of title) is removed to a certificate state and a certificate is issued therefor, the holder of a security interest has the same 4-month protection, subject to the provision discussed in the next paragraph of Comment.

(e) Where "this state" issues a certificate of title on collateral that has come from another state subject to a security interest perfected in any manner, problems will arise if this state, from whatever cause, fails to show on its certificate the security interest perfected in the other



jurisdiction. This state will have every reason, nevertheless, to make its certificate of title reliable to the type of person who most needs to rely on it. Paragraph (2)(d) (A.C.A. § 4-9-103(2)(d)) of the section therefore provides that the security interest perfected in the other jurisdiction is subordinate to the rights of a limited class of persons buying the goods while there is a clean certificate of title issued by this state, without knowledge of the security interest perfected in the other jurisdiction. The limited class are buyers who are non-professionals, i.e., not dealers and not secured parties, because these are ordinarily professionals. The protective rule mentioned does not apply if this state adopts a device used under some certificate of title laws, namely, stating on the certificate of title that the vehicle may be subject to security interests not shown on the certificate, where the collateral came from a non-certificate state.

In any event the security interest perfected out of state becomes unperfected unless reperfected in this state under the usual 4-month rule (paragraph (2)(d) (A.C.A. § 4-9-103(2)(d)) of the section). States which place a cautionary statement on a certificate of title coming from a non-certificate state make provision to re-issue the certificate without the caution after 4 months.

One difficulty is that no state's certificate of title law makes any provision by which a foreign security interest may be reperfected in that state, without the cooperation of the owner or other person holding the certificate in temporarily surrendering the certificate. But that cooperation is not likely to be forthcoming from an owner who wrongfully procured the issuance of a new certificate not showing the out-of-state security interest, or from a local secured party finding himself in a priority contest with the out-of-state secured party. The only solution for the out-of-state secured party under present certificate of title laws seems to be to reperfect by possession, i.e., by repossession of the goods.

5. The general rules of the section based on location of the collateral could not be applied to certain types of intangible collateral which have no location in any realistic sense, or to certain movable chattels which have no permanent location.

(a) For accounts and general intangibles there is no indispensable or symbolic document which represents the underlying claim, whose endorsement or delivery is the one effectual means of transfer. There is a considerable body of case law dealing with the situs of choses in action such as these. This case law is in the highest degree confused, contradictory and uncertain: it affords no base on which to build a statutory rule.

An account arises typically out of a sale; the contract of sale may be executed in State A, the goods shipped from a warehouse in State B to buyer (account debtor) in State C. The account may then be assigned to an assignee in State D. The seller-assignor may keep his principal records in State E. Under the non-notification system of accounts financing, the seller-assignor, despite the assignment, bills and collects from the account debtor; under notification financing the account debtor makes payment to the assignee, but the bills may be prepared and sent out by either assignor or assignee. The contacts of the transaction are with many jurisdictions: to which one is it appropriate to look for the governing law? Even more complicated situations may be anticipated when the collateral consists of novel or uncommon types of personal property, which fall within the definition of general intangibles.

If we bear in mind that our principal question is where certain financing statements shall be filed, two things become clear. First: since the purpose of filing is to allow subsequent creditors of the debtor-assignor to determine the true status of his affairs, the place chosen must be one which such creditors would normally associate with the assignor; thus the place of business of the assignee and the places of business or residences of the various account debtors must be rejected in ordinary situations. Second: the place chosen must be one which can be determined with the least possible risk of error. The place chosen by subsection (3) (A.C.A. § 4-9-103(3)) is the debtor's location, which is ordinarily the location of its chief executive office. This concept is discussed below.

(b) Another class of collateral for which a special rule is stated in subsection (3) (A.C.A. § 4-9-103(3)) is mobile goods of types which are normally moved for use from one jurisdiction to another. Such

goods are generally classified as equipment; sometimes they may be classified as inventory, for example, goods leased by a professional lessor. Subsection (3) (A.C.A. § 4-9-103(3)) provides that a security interest in such equipment or inventory is subject to this Article (Chapter) when the debtor's location, i.e., ordinarily its chief executive office, is in this state.

While automobiles are obviously mobile goods, they will in most cases be covered by subsection (2) (A.C.A. § 4-9-103(2)) of this section and therefore excluded from subsection (3) (A.C.A. § 4-9-103(3)) by paragraph (a) (A.C.A. § 4-9-103(3)(a)) thereof. If an automobile is not covered by a certificate of title and is classified as equipment or as inventory under lease, it will be subject to subsection (3) (A.C.A. § 4-9-103(3)). Automobiles and other mobile goods which are classified as consumer goods are not subject to subsection (3) (A.C.A. § 4-9-103(3)).

The rule of subsection (3) (A.C.A. § 4-9-103(3)) applies to goods of a type "normally used" in more than one jurisdiction; there is no requirement that particular goods be in fact used out of state. Thus, if an enterprise whose chief executive office is in State X keeps in State Y goods of the type covered by subsection (3) (A.C.A. § 4-9-103(3)), the rule of subsection (3) (A.C.A. § 4-9-103(3)) requires filing in State X even though the goods never leave State Y.

(c) "Chief executive office" does not mean the place of incorporation; it means the place from which in fact the debtor manages the main part of his business operations. This is the place where persons dealing with the debtor would normally look for credit information, and is the appropriate place for filing. The term "chief executive office" is not defined in this Section or elsewhere in this Act. Doubt may arise as to which is the "chief executive office" of a multi-state enterprise, but it would be rare that that there could be more than two possibilities. A secured party in such a case may easily protect himself at no great additional burden by filing in each possible place. The subsection states a rule which will be simple to apply in most cases, and which makes it possible to dispense with much burdensome and useless filing.

(d) If the location of the debtor is moved after a security interest has been perfected in another jurisdiction, the secured

party has four months within which to refile, unless the perfection in the original jurisdiction would have expired earlier (paragraph (3)(e) (A.C.A. § 4-9-103(3)(e))).

(e) Under subsection (3) (A.C.A. § 4-9-103(3)) each state other than that of the debtor's location in effect disclaims jurisdiction over certain accounts and general intangibles which, by common law rules, might be held to be within its jurisdiction; in the same way there is a disclaimer of jurisdiction over mobile chattels, even though they may be physically located within the state much of the time. If the jurisdiction whose law controls under this rule is a United States jurisdiction or has enacted legislation permitting perfection of the security interest by filing or recording in that jurisdiction, the law of that jurisdiction will be recognized in the disclaiming jurisdiction as perfecting the security interest. The jurisdiction of the debtor's location may not, however, have such legislation. For example, mobile equipment is used in New York; the debtor's chief place of business is in a Canadian jurisdiction which will not permit or recognize filing as to property not physically located therein. Paragraph (3)(c) (A.C.A. § 4-9-103(3)(c)) solves this difficulty by permitting perfection through filing in the jurisdiction in the United States in which the debtor has its major executive office in the United States. Where the debtor is not located in the United States or Canada and the collateral is accounts or general intangibles for money due or to become due, the secured party may alternatively perfect by notification to account debtors.

(f) A sentence in paragraph (3)(d) (A.C.A. § 4-9-103(3)(d)) provides a special rule for security interests in airplanes owned by a foreign air carrier. Without that sentence subsection (3) (A.C.A. § 4-9-103(3)) might refer such a case to the law of a foreign nation whose law is difficult or impossible to ascertain. The sentence clears up such doubts by treating as the location of the carrier the office designated for service of process in the United States under the Federal Aviation Act of 1958. To the extent that it is applicable, the Convention on the International Recognition of Rights in Aircraft (Geneva Convention) supersedes state legislation on this subject, as set forth in Section



9-302(3) (A.C.A. § 4-9-302(3)), but some nations are not parties to that Convention.

6. Subsection (4) (A.C.A. § 4-9-103(4)) deals with chattel paper, a semi-intangible security interest which may be perfected either by possession or by filing (Sections 9-304(1) (A.C.A. § 4-9-304(1)), 9-305 (A.C.A. § 4-9-305)). As to possessory security, subsection (4) (A.C.A. § 4-9-103(4)) provides that chattel paper shall be subject to the same rule as goods in subsection (1) (A.C.A. § 4-9-103(1)). As to non-possessory security, subsection (4) (A.C.A. § 4-9-103(4)) provides that it shall be subject to the same rule as the intangibles under subsection (3) (A.C.A. § 4-9-103(3)), except that notification to the account debtor is ruled out as an optional means of perfection under paragraph (3)(c) (A.C.A. § 4-9-103(3)(c)). The reason for this is that a different alternative, possession, is available for chattel paper.

7. In addition to the foregoing rules defining which jurisdiction governs perfection of a security interest in the first instance, "this state" (i.e., a destination state after removal) adds its own rules requiring reperfecting following removal of collateral other than that described in subsections (2) (A.C.A. § 4-9-103(2)), (3) (A.C.A. § 4-9-103(3)), and (5) (A.C.A. § 4-9-103(5)). "This state" will for four months recognize perfection under the law of the jurisdiction from which the collateral came, unless the remaining period of effectiveness of the perfection in that jurisdiction was less than four months (paragraph (1)(d) (A.C.A. § 4-9-103(1)(d))). After the four month period or the remaining period of effectiveness, whichever is shorter, the secured party must comply with perfection requirements in this state. This rule differs from the former rule of Section 14 of the Uniform Conditional Sales Act. Under that section a conditional seller was required to file within 10 days after he "received notice" that the goods had been removed into this state. Apparently, under the Uniform Conditional Sales Act, if the seller never "received notice" his interest continued or became perfected in this state without filing. Paragraph (1)(d) (A.C.A. § 4-9-103(1)(d)) proceeds on the theory that not only the secured party whose collateral has been removed but also creditors of and

purchasers from the debtor "In this state" should be considered.

The four-month period is long enough for a secured party to discover in most cases that the collateral has been removed and refile in this state; thereafter, if he has not done so, his interest, although originally perfected in the jurisdiction from which the collateral was removed, is subject to defeat here by purchasers of the collateral. Compare the situation arising under Section 9-403(2) (A.C.A. § 4-9-403(2)) when a filing lapses.

It should be noted that a "purchaser" includes a secured party. Section 1-201(32) (A.C.A. § 4-1-201(32)) and (33) (A.C.A. § 4-1-201(33)). The rights of a purchaser with a security interest against an unperfected security interest are governed by Section 9-312 (A.C.A. § 4-9-312).

In case of delay beyond the four-month period, there is no "relation back"; and this is also true where the security interest is perfected for the first time in this state.

If the removal occurs within a short period, like two weeks, before the lapse of the filing in the original state, the secured party has only that period, not the full four months to reperfect in "this state". But ordinarily he would have filed a continuation statement in the original jurisdiction; and he may do so to avoid lapse and allow himself the full four months if he is searching for the collateral and needs more time.

Paragraph (1)(d) (A.C.A. § 4-9-103(1)(d)) does not apply to the case of goods removed from one filing district to another within this state (see subsection (3) of Section 9-401 (A.C.A. § 4-9-401(3))), but only to property brought into this state from another jurisdiction.

8. Subsection (5) (A.C.A. § 4-9-103(5)) deals with problems relating to the financing of minerals (including oil and gas) as these products come from the ground. In some cases rights in oil and gas in the ground have been split into a large variety of interests. As the oil or gas issues from the ground, it may be encumbered by the group of persons having interests therein. Or the product may be sold at minehead or wellhead and the resulting accounts assigned. The question arises as to the place of filing. The usual rule of this section in subsection (3) (A.C.A. § 4-9-103(3)) would make the place to search for

encumbrances on the accounts the locations of the respective assignors; but the assignors might be a number of individuals located throughout the country. To avoid the difficult problems of search thus created, subsection (5) (A.C.A. § 4-9-103(5)) provides that the place for filing with respect to security interests in the minerals as they issue from the ground at minehead or wellhead or in the accounts arising out of the sale of the minerals at minehead or wellhead shall be in the state where the minehead or wellhead is located. Section 9-401 (A.C.A. § 4-9-401) similarly provides that the place to file within the state is in the real property records in the county where the minehead or wellhead is located. These rules conform to pre-Code practice and to practice which seems to have continued in the early Code period before express provision was made for these situations.

The term "at wellhead" is intended to encompass arrangements based on sale of the product as soon as it issues from the ground and is measured, without technical distinctions as to whether title passes at the "Christmas tree" or the far side of a gathering tank or at some other point. The term "at minehead" is a comparable concept.

#### *Cross References:*

Sections 1-105 (A.C.A. § 4-1-105), 9-302 (A.C.A. § 4-9-302), and 9-401 (A.C.A. § 4-9-401).

#### *Definitional Cross References:*

"Accounts". Section 9-106 (A.C.A. § 4-9-106).

"Attaches". Section 9-203 (A.C.A. § 4-9-203).

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Consumer goods". Section 9-109 (A.C.A. § 4-9-109).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Document". Section 9-105 (A.C.A. § 4-9-105).

"Equipment". Section 9-109 (A.C.A. § 4-9-109).

"General intangibles". Section 9-106 (A.C.A. § 4-9-106).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Instrument". Section 9-109 (A.C.A. § 4-9-109).

"Purchase money security interest". Section 9-107 (A.C.A. § 4-9-107).

"Purchaser". Section 1-201(33) (A.C.A. § 4-1-201(33)).

"Security interest". Section 1-201(37) (A.C.A. § 4-1-201(37)).

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\*This section was amended by: Acts 1967, No. 303, § 29, to adopt the optional language in subsection (2) and to adopt optional subsection (5); Acts 1973, No. 116, § 1 (9-103), to incorporate the 1972 changes to this Uniform Commercial Code section; and Acts 1985, No. 514, §§ 4, 5, to incorporate the 1977 changes to the Uniform Commercial Code.

### **1972 Official Comment to § 9-104 (A.C.A. § 4-9-104)\***

*Prior Uniform Statutory Provision:* None.

#### *Purposes:*

To exclude certain security transactions from this Article (Chapter).

1. Where a federal statute regulates the incidents of security interests in particular types of property, those security interests are of course governed by the federal statute and excluded from this Article (Chapter). The Ship Mortgage Act, 1920, is an example of such a federal act. The present provisions of the Federal Aviation Act of 1958 (49 U.S.C. § 1403 et seq.) call for registration of title to and liens upon aircraft with the Civil Aeronau-

tics Administrator and such registration is recognized as equivalent to filing under this Article (Chapter) (Section 9-302(3) (A.C.A. § 4-9-302(3))); but to the extent that the Federal Aviation Act does not regulate the rights of parties to and third parties affected by such transactions, security interests in aircraft remain subject to this Article (Chapter).

Although the Federal Copyright Act contains provisions permitting the mortgage of a copyright and for the recording of an assignment of a copyright (17 U.S.C. §§ 28, 30) such a statute would not seem to contain sufficient provisions regulating



the rights of the parties and third parties to exclude security interests in copyrights from the provisions of this Article (Chapter). Compare *Republic Pictures Corp. v. Security-First National Bank of Los Angeles*, 197 F.2d 767 (9th Cir. 1952). Compare also with respect to patents, 35 U.S.C. § 47. The filing provisions under these Acts, like the filing provisions of the Federal Aviation Act, are recognized as the equivalent to filing under this Article (Chapter). Section 9-302(3) (A.C.A. § 4-9-302(3)) and (4) (A.C.A. § 4-9-302(4)).

Even such a statute as the Ship Mortgage Act is far from a comprehensive regulation of all aspects of ship mortgage financing. That Act contains provisions on formal requisites, on recordation and on foreclosure but not much more. If problems arise under a ship mortgage which are not covered by the Act, the federal admiralty court must decide whether to improvise an answer under "federal law" or to follow the law of some state with which the mortgage transaction has appropriate contacts. The exclusionary language in paragraph (a) (A.C.A. § 4-9-104(a)) is that this Article (Chapter) does not apply to such security interest "to the extent" that the federal statute governs the rights of the parties. Thus if the federal statute contained no relevant provision, this Article (Chapter) could be looked to for an answer.

2. Except for fixtures (Section 9-313 (A.C.A. § 4-9-313)), the Article (Chapter) applies only to security interests in personal property. The exclusion of landlord's liens by paragraph (b) (A.C.A. § 4-9-104(b)) and of leases and other interests in or liens on real estate by paragraph (j) (A.C.A. § 4-9-104(j)) merely reiterates the limitations on coverage already made explicit in Section 9-102(3) (A.C.A. § 4-9-102(3)). See Comment 4 to that section.

3. In all jurisdictions liens are given suppliers of many types of services and materials either by statute or by common law. It was thought to be both inappropriate and unnecessary for this Article (Chapter) to attempt a general codification of that lien structure which is in considerable part determined by local conditions and which is far removed from ordinary commercial financing. Moreover, federal law may displace state law in situations such as admiralty liens. Paragraph (c) (A.C.A. § 4-9-104(c)) therefore

excludes statutory liens from the Article (Chapter). Section 9-310 (A.C.A. § 4-9-310) states a rule for determining priorities between such liens and the consensual security interests covered by this Article (Chapter).

4. In many states assignments of wage claims and the like are regulated by statute. Such assignments present important social problems whose solution should be a matter of local regulation. Paragraph (d) (A.C.A. § 4-9-104(d)) therefore excludes them from this Article (Chapter).

5. Certain governmental borrowings include collateral in the form of assignments of water, electricity or sewer charges, rents on dormitories or industrial buildings, tools, etc. Since these assignments are usually governed by special provisions of law, these governmental transfers are excluded from this Article (Chapter).

6. In general sales as well as security transfers of accounts and chattel paper are within the Article (Chapter) (see Section 9-102 (A.C.A. § 4-9-102)). Paragraph (f) (A.C.A. § 4-9-104(f)) excludes from the Article (Chapter) certain transfers of such intangibles which, by their nature, have nothing to do with commercial financing transactions.

Similarly, this paragraph excludes from the Article (Chapter) such transactions as that involved in *Lyon v. Ty-Wood Corporation*, 212 Pa.Super. 69, 239 A.2d 819 (1968) and *Spurlin v. Sloan*, 368 S.W.2d 314 (Ky.1963).

7. Rights under life insurance and other policies, and deposit accounts, are often put up as collateral. Such transactions are often quite special, do not fit easily under a general commercial statute and are adequately covered by existing law. Paragraphs (g) (A.C.A. § 4-9-104(g)) and (l) (A.C.A. § 4-9-104(l)) make appropriate exclusions, but provision is made for coverage of deposit accounts and certain insurance money as proceeds.

8. The remaining exclusions go to other types of claims which do not customarily serve as commercial collateral: judgments under paragraph (h) (A.C.A. § 4-9-104(h)), setoffs under paragraph (i) (A.C.A. § 4-9-104(i)) and tort claims under paragraph (k) (A.C.A. § 4-9-104(k)).

#### *Cross References:*

Point 1: Section 9-302(3) (A.C.A. § 4-9-302(3)).

Point 2: Sections 9-102(3) (A.C.A. § 4-9-102(3)) and 9-313 (A.C.A. § 4-9-313).

Point 3: Sections 9-102(2) (A.C.A. § 4-9-102(2)) and 9-310 (A.C.A. § 4-9-310).

Point 6: Section 9-102 (A.C.A. § 4-9-102).

*Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Deposit account". Section 9-105 (A.C.A. § 4-9-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

\*This section was amended by Acts 1973 No. 116 § 1 (9-104), to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-105 (A.C.A. § 4-9-105)\***

*Prior Uniform Statutory Provision:* Various.

*Purposes:*

1. General. It is necessary to have a set of terms to describe the parties to a secured transaction, the agreement itself, and the property involved therein; but the selection of the set of terms applicable to any one of the existing forms (e.g., mortgagor and mortgagee) might carry to some extent the implication that the existing law referable to that form was to be used for the construction and interpretation of this Article (Chapter). Since it is desired to avoid any such implication, a set of terms has been chosen which have no common law or statutory roots tying them to a particular form.

In place of such terms as "chattel mortgage," "conditional sale," "assignment of accounts receivable," "trust receipt," etc., this Article (Chapter) substitutes the general term "security agreement" defined in paragraph (1)(l) (A.C.A. § 4-9-105(1)(l)). In place of "mortgagor," "mortgagee," "conditional vendee," "conditional vendor," etc., this Article (Chapter) substitutes "debtor", defined in paragraph (1)(d) (A.C.A. § 4-9-105(1)(d)), and "secured party", defined in paragraph (1)(m) (A.C.A. § 4-9-105(1)(m)). The property subject to the security agreement is "collateral", defined in paragraph (1)(c) (A.C.A. § 4-9-105(1)(c)). The interest in the collateral which is conveyed by the debtor to the secured party is a "security interest", defined in Section 1-201(37) (A.C.A. § 4-1-201(37)).

2. Parties. The parties to the security agreement are the "debtor" and the "secured party."

"Debtor": In all but a few cases the person who owes the debt and the person whose property secures the debt will be the same. Occasionally, one person furnishes security for another's debt, and sometimes property is transferred subject to a secured debt of the transferor which the transferee does not assume; in such cases, under the second sentence of the definition, the term "debtor" may, depending upon the context, include either or both persons. Section 9-112 (A.C.A. § 4-9-112) sets out special rules which are applicable where collateral is owned by a person who does not owe a debt.

"Secured party": The term includes any person in whose favor there is a security interest (defined in Section 1-201 (A.C.A. § 4-1-201)). The term is used equally to refer to a person who as a seller retains a lien on or title to goods sold, to a person whose interest arises initially from a loan transaction, and to an assignee of either. Note that a seller is a "secured party" in relation to his customer; the seller becomes a "debtor" if he assigns the chattel paper as collateral. This is also true of a lender who assigns the debt as collateral. With the exceptions stated in Section 9-104(f) (A.C.A. § 4-9-104(f)) the Article (Chapter) applies to any sale of accounts or chattel paper: the term "secured party" includes an assignee of such intangibles whether by sale or for security, to distinguish him from the payee of the account, for example, who becomes a "debtor" by pledging the account as security for a loan.

On the applicability of the terms "debtor" and "secured party" to consignments and leases see Section 9-408 (A.C.A. § 4-9-408) and Comment thereto.



"Account debtor": Where the collateral is an account, chattel paper or general intangible the original obligor is called the "account debtor", defined in paragraph (1)(a) (A.C.A. § 4-9-105(1)(a)).

3. Property subject to the security agreement. "Collateral", defined in paragraph (1)(c) (A.C.A. § 4-9-105(1)(c)), is a general term for the tangible and intangible property subject to a security interest. For some purposes the Code makes distinctions between different types of collateral and therefore further classification of collateral is necessary. Collateral which consists of tangible property is "goods", defined in paragraph (1)(h) (A.C.A. § 4-9-105(1)(h)); and "goods" are again subdivided in Section 9-109 (A.C.A. § 4-9-109). For purposes of this Article (Chapter) all intangible collateral fits one of five categories, two of which, "accounts", and "general intangibles" are defined in the following Section 9-106 (A.C.A. § 4-9-106); the other three, "documents", "instruments" and "chattel paper" are defined in paragraphs (1)(f) (A.C.A. § 4-9-105(1)(f)), (1)(i) (A.C.A. § 4-9-105(1)(i)) and (1)(b) (A.C.A. § 4-9-105(1)(b)) of this section.

"Goods": The definition in paragraph (1)(h) (A.C.A. § 4-9-105(1)(h)) is similar to that contained in Section 2-105 (A.C.A. § 4-2-105) except that the Sales Article (Chapter) definition refers to "time of identification to the contract for sale", while this definition refers to "the time the security interest attaches."

For the treatment of fixtures, Section 9-313 (A.C.A. § 4-9-313) should be consulted. It will be noted that the treatment of fixtures under Section 9-313 (A.C.A. § 4-9-313) does not at all points conform to their treatment under Section 2-107 (A.C.A. § 4-2-107) (goods to be severed from realty). Section 2-107 (A.C.A. § 4-2-107) relates to sale of such goods; Section 9-313 (A.C.A. § 4-9-313) to security interests in them. The discrepancies between the two sections arise from the differences in the types of interest covered. A comparable discrepancy exists as to minerals. In the case of timber, both sections treat it as goods if it is to be severed under a contract of sale, but not otherwise.

If in any state minerals before severance are deemed to be personal property, they fall outside the Article's (Chapter's) definition of "goods" and would therefore fall in the catch-all definition, "general

intangibles", in Section 9-106 (A.C.A. § 4-9-106). The special provisions of the Section 9-103(5) (A.C.A. § 4-9-103(5)) would not apply and those of Section 9-103(3) (A.C.A. § 4-9-103(3)) would apply. The resulting problems should be considered locally.

For the purpose of this Article (Chapter), goods are classified as "consumer goods", "equipment", "farm products", and "inventory"; those terms are defined in Section 9-109 (A.C.A. § 4-9-109). When the general term "goods" is used in this Article (Chapter), it includes, as may be appropriate in the context, the subclasses of goods defined in Section 9-109 (A.C.A. § 4-9-109).

"Instrument": The term as defined in paragraph (1)(i) (A.C.A. § 4-9-105(1)(i)) includes not only negotiable instruments and certificated securities but also any other intangibles evidenced by writings which are in ordinary course of business transferred by delivery. As in the case of chattel paper "delivery" is only the minimum stated and may be accompanied by other steps.

If a writing is itself a security agreement or lease with respect to specific goods it is not an instrument although it otherwise meets the term of the definition. See Comment below on "chattel paper".

The fact that an instrument is secured by collateral, whether the collateral be other instruments, documents, goods, accounts or general intangibles, does not change the character of the principal obligation as an instrument or convert the combination of instrument and collateral into a separate Code classification of personal property. The single qualification to this principle is that an instrument which is secured by chattel paper is itself part of the chattel paper, while also retaining its identity as an instrument.

"Document": See the Comments under Sections 1-201(15) (A.C.A. § 4-1-201(15)) and 7-201 (A.C.A. § 4-7-201).

"Chattel paper": To secure his own financing a secured party may wish to borrow against or sell the security agreement itself along with his interest in the collateral which he has received from his debtor. Since the refinancing of paper secured by specific goods presents some problems of its own, the term "chattel paper" is used to describe this kind of collateral. The Comments under Section

9-308 (A.C.A. § 4-9-308) further describe this concept.

Charters of vessels are excluded from the definition of chattel paper because they fit under the definition of accounts. See Comment to Section 9-106 (A.C.A. § 4-9-106). The term "charter" as used herein and in Section 9-106 (A.C.A. § 4-9-106) includes bareboat charters, time charters, successive voyage charters, contracts of affreightment, contracts of carriage, and all other arrangements for use of vessels.

4. The following transactions illustrate the use of the term "chattel paper" and some of the other terms defined in this section.

A dealer sells a tractor to a farmer on conditional sales contract or purchase money security interest. The conditional sales contract is a "security agreement", the farmer is the "debtor", the dealer is the "secured party" and the tractor is the type of "collateral" defined in Section 9-109 (A.C.A. § 4-9-109) as "equipment". But now the dealer transfers the contract to his bank, either by outright sale or to secure a loan. Since the conditional sales contract is a security agreement relating to specific equipment, the conditional sales contract is now the type of collateral called "chattel paper". In this transaction between the dealer and his bank, the bank is the "secured party", the dealer is the "debtor", and the farmer is the "account debtor".

Under the definition of "security interest" in Section 1-201(37) (A.C.A. § 4-1-201(37)) a lease does not create a security interest unless intended as security. Whether or not the lease itself is a security agreement, it is chattel paper when transferred if it relates to specific goods. Thus, if the dealer enters into a straight lease of the tractor to the farmer (not intended as security), and then arranges to borrow money on the security of the lease, the lease is chattel paper.

Security agreements of the type formerly known as chattel mortgages and conditional sales contracts are frequently executed in connection with a negotiable note or a series of such notes. Under the definitions in paragraphs (1)(b) (A.C.A. § 4-9-105(1)(b)) and (1)(i) (A.C.A. § 4-9-105(1)(i)) the rules applicable to chattel paper, rather than those relating to instruments, are applicable to the group of

writings (contract plus note) taken together.

#### 5. Miscellaneous definitions.

"Deposit account" is a type of collateral excluded from this Article (Chapter) under Section 9-104(l) (A.C.A. § 4-9-104(l)), except when it constitutes proceeds of other collateral under Section 9-306 (A.C.A. § 4-9-306).

The terms "encumbrance" and "mortgage" are defined for use in the section on fixtures, Section 9-113 (A.C.A. § 4-9-113).

The term "transmitting utility" is defined to designate a special class of debtors for whom separate filing rules are provided in Part 4, thus obviating all local filing and particularly the several local filings that would be necessary under the usual rules of Section 9-401 (A.C.A. § 4-9-401) for the fixture collateral of a far-flung public utility debtor. See Comments under Sections 9-401 (A.C.A. § 4-9-401) and 9-403 (A.C.A. § 4-9-403).

The term "pursuant to commitment" is defined for use in the rules relating to priority of future advances in Sections 9-301(4) (A.C.A. § 4-9-301(4)), 9-307(3) (A.C.A. § 4-9-307(3)), and 9-312(7) (A.C.A. § 4-9-312(7)).

6. Comments to the definitions indexed in subsections (2) (A.C.A. § 4-9-105(2)) and (3) (A.C.A. § 4-9-105(3)) follow the sections in which the definitions are contained.

#### *Cross References:*

Point 2: Sections 9-104(f) (A.C.A. § 4-9-104(f)) and 9-112 (A.C.A. § 4-9-112).

Point 3: Sections 2-105 (A.C.A. § 4-2-105), 2-107 (A.C.A. § 4-2-107), 9-106 (A.C.A. § 4-9-106), 9-109 (A.C.A. § 4-9-109), 9-303 (A.C.A. § 4-9-303) and 9-313 (A.C.A. § 4-9-313).

#### *Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Document of title". Sections 1-201 (A.C.A. § 4-1-201), 7-201 (A.C.A. § 4-7-201).

"General intangibles". Section 9-106 (A.C.A. § 4-9-106).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Money". Section 1-201 (A.C.A. § 4-1-201).



"Negotiable instrument". Section 3-104 (A.C.A. § 4-3-104).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Representative". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Security". Section 8-102 (A.C.A. § 4-8-102).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-105), to incorporate the 1972 changes to this Uniform Commercial Code section, and by Acts 1985, No. 514, § 6, to incorporate the 1977 changes to this Uniform Commercial Code section.

### 1972 Official Comment to § 9-106 (A.C.A. § 4-9-106)\*

*Prior Uniform Statutory Provision:* None.

*Purposes:*

The terms defined in this section round out the classification of intangibles: see the definitions of "document", "chattel paper" and "instrument" in Section 9-105 (A.C.A. § 4-9-105). Those three terms cover the various categories of commercial paper which are either negotiable or to a greater or less extent dealt with as if negotiable. The term "account" covers most choses in action which may be the subject of commercial financing transactions but which are not evidenced by an indispensable writing. The term "general intangibles" brings under this Article (Chapter) miscellaneous types of contractual rights and other personal property which are used or may become customarily used as commercial security. Examples are goodwill, literary rights and rights to performance. Other examples are copyrights, trademarks and patents, except to the extent that they may be excluded by Section 9-104(a) (A.C.A. § 4-9-104(a)). This Article (Chapter) solves the problems of filing of security interests in these types of intangibles (Section 9-103(3) (A.C.A. § 4-9-103(3)) and 9-401 (A.C.A. § 4-9-401)). Note that this catch-all definition does not apply to money or to types of intangibles which are specifically excluded from the coverage of the Article (Chapter) (Section 9-104 (A.C.A. § 4-9-104)) and note also that under Section 9-302 (A.C.A. § 4-9-302) filing under a federal statute may satisfy the filing requirements of this Article (Chapter).

A right to the payment of money is frequently buttressed by ancillary covenants to insure the preservation of collateral, such as covenants in a purchase

agreement, note or mortgage requiring insurance on the collateral or forbidding removal of the collateral; or covenants to preserve creditworthiness of the promisor, such as covenants restricting dividends, etc. While these miscellaneous ancillary rights might conceivably be thought to fall within the definition of "general intangibles", it is not the intention of the Code\* to treat them separately and require the perfection of assignment thereof by filing in the manner required for perfection of an assignment of general intangibles. Whatever perfection is required for the perfection of an assignment of the right to the payment of money will also carry these ancillary rights.

Similarly, when the right to the payment of money is not yet earned by performance, there are frequently ancillary rights designed to assure that an assignee may complete the performance and crystallize the right to payment of money. Such rights are frequently present in a "maintenance" lease where the lessor has continuing duties to perform, or in a ship charter. These ancillary rights, if considered in the abstract, might be thought to be "general intangibles", since they do not themselves involve the payment of money; but it is not the intent of the Code to split up the rights to the payment of money and its ancillary supports, and thereby multiply the problem of perfection of assignments. Therefore, all rights of the lessor in a lease are to be perfected as "chattel paper", and all rights of the owner in a ship charter are to be perfected as "accounts".

"Account" is defined as a right to payment for goods sold or leased or services rendered; the ordinary commercial ac-

count receivable. In some special cases a right to receive money not yet earned by performance crystallizes not into an account but into a general intangible, for it is a right to payment of money that is not "for goods sold or leased or for services rendered." Examples of such rights are the right to receive payment of a loan not evidenced by an instrument or chattel paper; a right to receive partial refund of purchase prices paid by reason of retroactive volume discounts; rights to receive payment under licenses of patents and copyrights, exhibition contracts, etc.

This Article (Chapter) rejects any lingering common law notion that only rights already earned can be assigned. In the triangular arrangement following assignment, there is reason to allow the original parties — assignor and account debtor — more flexibility in modifying the underlying contract before performance than after performance (see Section 9-318 (A.C.A. § 4-9-318)). It will, however, be found that in most situations the same rules apply to

accounts both before and after performance.

*Cross References:*

Sections 9-103(2) (A.C.A. § 4-9-103(2)), 9-104 (A.C.A. § 4-9-104), 9-302(3) (A.C.A. § 4-9-302(3)), 9-318 (A.C.A. § 4-9-318) and 9-401 (A.C.A. § 4-9-401).

*Definitional Cross References:*

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 9-105 (A.C.A. § 4-9-105).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Instrument". Section 9-105 (A.C.A. § 4-9-105).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-106), to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-107 (A.C.A. § 4-9-107)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Under existing rules of law and under this Article (Chapter) purchase money obligations often have priority over other obligations. Thus a purchase money obligation has priority over an interest acquired under an after-acquired property clause (Section 9-312(3) (A.C.A. § 4-9-312(3)) and (4) (A.C.A. § 4-9-312(4))); where filing is required a grace period of ten days is allowed against creditors and transferees in bulk (Section 9-301(2) (A.C.A. § 4-9-301(2))); and in some instances filing may not be necessary (Section 9-302(1)(c) (A.C.A. § 4-9-302(1)(c)) and (d) (A.C.A. § 4-9-302(1)(d))).

Under this Section a seller has a purchase money security interest if he retains a security interest in the goods; a financing agency has a purchase money security interest when it advances money to the seller, taking back an assignment of chattel paper, and also when it makes advances to the buyer (e.g., on chattel mortgage) to enable him to buy, and he uses the money for that purpose.

2. When a purchase money interest is claimed by a secured party Who is not a

seller, he must of course have given present consideration. This Section therefore provides that the purchase money party must be one who gives value "by making advances or incurring an obligation": the quoted language excludes from the purchase money category any security interest taken as security for or in satisfaction of a pre-existing claim or antecedent debt.

*Cross References:*

Point 1: Sections 9-301 (A.C.A. § 4-9-301), 9-302 (A.C.A. § 4-9-302) and 9-312 (A.C.A. § 4-9-312).

Point 2: Section 9-108 (A.C.A. § 4-9-108).

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-9-201).



**1972 Official Comment to § 9-108 (A.C.A. § 4-9-108)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Many financing transactions contemplate that the collateral will include both the debtor's existing assets and also assets thereafter acquired by him in the operation of his business. This Article (Chapter) generally validates such after-acquired property interests (see Section 9-204 (A.C.A. § 4-9-204) and Comment) although they may be subordinated to later purchase money interests under Section 9-312(3) (A.C.A. § 4-9-312(3)) and (4) (A.C.A. § 4-9-312(4)).

Interests in after-acquired property have never been considered as involving transfers of property for antecedent debt merely because of the after-acquired feature, nor should they be so considered. The section makes explicit what has been true under the case law: an after-acquired property interest is not, by virtue of that fact alone, security for a pre-existing claim. This rule is of importance principally in insolvency proceedings under the federal Bankruptcy Act or state statutes which make certain transfers for antecedent debt voidable as preferences. The determination of when a transfer is for antecedent debt is largely left by the Bankruptcy Act to state law.

Two tests must be met under this section for an interest in after-acquired property to be one not taken for an antecedent debt. First: the secured party must, at the inception of the transaction, have given new value in some form. Second: the after-acquired property must come in either in the ordinary course of the debtor's business or as an acquisition which is made under a contract of purchase entered into within a reasonable time after the giving of new value and pursuant to the security agreement. The reason for the first test needs no comment. The second is in line with limitations which judicial construction has placed on the operation of after-acquired property clauses. Their coverage has been in many cases restricted to subsequent ordinary course acquisitions: this Article (Chapter) does not go so far (see Section 9-204 (A.C.A. § 4-9-204) and

Comment), but it does deny present value status to out of ordinary course acquisitions not made pursuant to the original loan agreement. This solution gives the secured party full protection as to the collateral which he may be reasonably thought to have contracted for; it gives other creditors the possibility, under the law of preferences, of subjecting to their claims windfall or unanticipated acquisitions shortly before bankruptcy.

2. The term "value" is defined in Section 1-201(44) (A.C.A. § 4-1-201(44)) and discussed in the accompanying Comment. In this section and in other sections of this Article (Chapter) the term "new value" is used but is left without statutory definition. The several illustrations of "new value" given in the text of this section (making an advance, incurring an obligation, releasing a perfected security interest) as well as the "purchase money security interest" definition in Section 9-107 (A.C.A. § 4-9-107) indicate the nature of the concept. In other situations it is left to the courts to distinguish between "new" and "old" value, between present considerations and antecedent debt.

*Cross References:*

Point 1: Sections 9-204 (A.C.A. § 4-9-204) and 9-312 (A.C.A. § 4-9-312).

Point 2: Section 9-107 (A.C.A. § 4-9-107).

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

**1972 Official Comment to § 9-109 (A.C.A. § 4-9-109)\***

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. This section classifies goods as consumer goods, equipment, farm products and inventory. The classification is important in many situations: it is relevant, for example, in determining the rights of persons who buy from a debtor goods subject to a security interest (Section 9-307 (A.C.A. § 4-9-307)), in certain questions of priority (Section 9-312 (A.C.A. § 4-9-312)), in determining the place of filing (Section 9-401 (A.C.A. § 4-9-401)) and in working out rights after default (Part 5). Comment 5 to Section 9-102 (A.C.A. § 4-9-102) contains an index of the special rules applicable to different classes of collateral.

2. The classes of goods are mutually exclusive; the same property cannot at the same time and as to the same person be both equipment and inventory, for example. In borderline cases — a physician's car or a farmer's utility vehicle which might be either consumer goods or equipment — the principal use to which the property is put should be considered as determinative. Goods can fall into different classes at different times; a radio is inventory in the hands of a dealer and consumer goods in the hands of a householder.

3. The principal test to determine whether goods are inventory is that they are held for immediate or ultimate sale. Implicit in the definition is the criterion that the prospective sale is in the ordinary course of business. Machinery used in manufacturing, for example, is equipment and not inventory even though it is the continuing policy of the enterprise to sell machinery when it becomes obsolete. Goods to be furnished under a contract of service are inventory even though the arrangement under which they are furnished is not technically a sale. When an enterprise is engaged in the business of leasing a stock of products to users (for example, the fleet of cars owned by a car rental agency), that stock is also included within the definition of "inventory". It should be noted that one class of goods which is not held for disposition to a purchaser or user is included in inventory: "Materials used or consumed in a busi-

ness". Examples of this class of inventory are fuel to be used in operations, scrap metal produced in the course of manufacture, and containers to be used to package the goods. In general it may be said that goods used in a business are equipment when they are fixed assets or have, as identifiable units, a relatively long period of use; but are inventory, even though not held for sale, if they are used up or consumed in a short period of time in the production of some end product.

4. Goods are "farm products" only if they are in the possession of a debtor engaged in farming operations. Animals in a herd of livestock are covered whether they are acquired by purchase or result from natural increase. Products of crops or livestock remain farm products so long as they are in the possession of a debtor engaged in farming operations and have not been subjected to a manufacturing process. The terms "crops", "livestock" and "farming operations" are not defined; however, it is obvious from the text that "farming operations" includes raising livestock as well as crops; similarly, since eggs are products of livestock, livestock includes fowl.

When crops or livestock or their products come into the possession of a person not engaged in farming operations they cease to be "farm products". If they come into the possession of a marketing agency for sale or distribution or of a manufacturer or processor as raw materials, they become inventory.

Products of crops or livestock, even though they remain in the possession of a person engaged in farming operations, lose their status as farm products if they are subjected to a manufacturing process. What is and what is not a manufacturing operation is not determined by this Article (Chapter). At one end of the scale some processes are so closely connected with farming — such as pasteurizing milk or boiling sap to produce maple syrup or maple sugar — that they would not rank as manufacturing. On the other hand an extensive canning operation would be manufacturing. The line is one for the courts to draw. After farm products have been subjected to a manufacturing operation, they become inventory if held for sale.



Note that the buyer in ordinary course who under Section 9-307 (A.C.A. § 4-9-307) takes free of a security interest in goods held for sale does not include one who buys farm products from a person engaged in farming operations.

5. The principal definition of equipment is a negative one: goods used in a business (including farming or a profession) which are not inventory and not farm products. Trucks, rolling stock, tools, machinery are typical. It will be noted furthermore that any goods which are not covered by one of the other definitions in this section are to be treated as equipment.

*Cross References:*

Point 1: Sections 9-102 (A.C.A. § 4-9-102), 9-307 (A.C.A. § 4-9-307), 9-312 (A.C.A. § 4-9-312), 9-401 (A.C.A. § 4-9-401) and Part 5.

Point 3: Section 9-307 (A.C.A. § 4-9-307).

Point 4: Section 9-307 (A.C.A. § 4-9-307).

*Definitional Cross References:*

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Organization". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Sections 2-106 (A.C.A. § 4-2-106) and 9-105 (A.C.A. § 4-9-105).

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\*This section was amended by Acts 1971, No. 363, § 1, to include fish grown for sale on fish farms in the definition of farm products in subsection (3), thus making it vary from the official text. The section also was amended by Acts 1973, No. 116, § 1, to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-110 (A.C.A. § 4-9-110)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

The requirement of description of collateral (see Section 9-203 (A.C.A. § 4-9-203) and Comment thereto) is evidentiary. The test of sufficiency of a description laid down by this section is that the description do the job assigned to it — that it make possible the identification of the thing described.

Under this rule courts should refuse to follow the holdings, often found in the

older chattel mortgage cases, that descriptions are insufficient unless they are of the most exact and detailed nature, the so-called "serial number" test. The same test of reasonable identification applies where a description of real estate is required in a financing statement. See Section 9-402 (A.C.A. § 4-9-402).

*Cross References:*

Sections 9-203 (A.C.A. § 4-9-203) and 9-402 (A.C.A. § 4-9-402).

**1972 Official Comment to § 9-111 (A.C.A. § 4-9-111)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

The bulk transfer laws, which have been almost everywhere enacted, were designed to prevent a once prevalent type of fraud which seems to have flourished particularly in the retail field: the owner of a debt-burdened enterprise would sell it to an unwary purchaser and then remove himself, with the purchase price and his other assets, beyond the reach of process. The creditors would find themselves with no recourse unless they could establish

that the purchaser assumed existing debts. The bulk transfer laws, which require advance notice of sale to all known creditors, seem to have been successful in preventing such frauds.

There has been disagreement whether the bulk transfer laws should be applied to security as well as to sale transactions. In most states security transactions have not been covered; in a few states the opposite result has been reached either by judicial construction or by express statutory provision. Whatever the reasons may

be, it seems to be true that the bulk transfer type of fraud has not often made its appearance in the security field: it may be that lenders of money are more inclined to investigate a potential borrower than are purchasers of retail stores to determine the true state of their vendor's affairs. Since compliance with the bulk transfer laws is onerous and expensive, legitimate financing transactions should not be required to comply when there is no reason to believe that other creditors will be prejudiced.

This section merely reiterates the provisions of Article 6 (Chapter 6) on Bulk Transfers which provides in Section 6-103(1) (A.C.A. § 4-6-103(1)) that transfers "made to give security for the performance of an obligation" are not subject to that Article (Chapter).

*Cross Reference:*

Section 6-103(1) (A.C.A. § 4-6-103(1)).

*Definitional Cross Reference:*

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

**1972 Official Comment to § 9-112 (A.C.A. § 4-9-112)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

Under the definition of Section 9-105 (A.C.A. § 4-9-105), in any provisions of the Article (Chapter) dealing with the collateral the term "debtor" means the owner of the collateral even though he is not the person who owes payment or performance of the obligation secured. This section covers several situations in which the implications of this definition are specifically set out.

The duties which this section imposes on a secured party toward such an owner of collateral are conditioned on the secured party's knowledge of the true state of facts. Short of such knowledge he may continue to deal exclusively with the person who owes the obligation. Nor does the section suggest that the secured party is under any duty of inquiry. It does not purport to cut across the law of conversion or of ultra vires. Whether a person who does not own property has authority to encumber it for his own debts and whether a person is free to encumber his property as collateral for the debts of

another, are matters to be decided under other rules of law and are not covered by this section.

The section does not purport to be an exhaustive treatment of the subject. It isolates certain problems which may be expected to arise and states rules as to them. Others will no doubt arise: their solution is left to the courts.

*Cross References:*

Sections 9-105 (A.C.A. § 4-9-105), 9-208 (A.C.A. § 4-9-208) and Part 5.

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Receive notice". Section 1-201 (A.C.A. § 4-1-201).

"Right". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

**Official Comment to Section 9-113 (A.C.A. § 4-9-113)**

*Uniform Statutory Source:* Section 9-113 (§ 4-9-113), 1978 Official Text of the Act (§ 4-1-101 et seq.).

*Changes:* This section is amended to include security interests arising under the Article on Leases (Article 2A) (§ 4-2A-101 et seq.), which is being promulgated at the same time as this amendment. Section 2A-508(5) (§ 4-2A-508(5)). After the effective date of the amendment to this section

all references in the Act (§ 4-1-101 et seq.) to Section 9-113 (§ 4-9-113) will be deemed to refer to this section, as amended. E.g., Sections 9-203(1) and 9-302(1)(f) (§§ 4-9-203(1) and 4-9-302(1)(f)).

*Cross References:*

Article 2A, esp. Section 2A-508(5) (§ 4-2A-101 et seq., esp. § 4-2A-508(5)).



*Definitional Cross References:*

"Agreement". Section 1-201(3) (§ 4-1-201(3)).

"Goods". Section 2A-103(1) (h) (§ 4-2A-103(1) (h)).

"Lease". Section 2A-103(1)(j) (§ 4-2A-103(1)(j)).

"Party". Section 1-201(29) (§ 4-1-201(29)).

"Rights". Section 1-201(36) (§ 4-1-201(36)).

"Sale". Section 2-106(1) (§ 4-2-106(1)).

"Security interest". Section 1-201(37) (§ 4-1-201(37)).

**1972 Official Comment to § 9-114 (A.C.A. § 4-9-114)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. This section requires that where goods are furnished to a merchant under the arrangement known as consignment rather than in a security transaction, the consignor must, in order to protect his position as against an inventory secured party of the consignee, give to that party the same notice and at the same time that he would give to that party if that party had filed first with respect to inventory and if the consigner were furnishing the goods under an inventory security agreement instead of under a consignment.

For the distinction between true consignment and security arrangements, see Section 1-201(37) (A.C.A. § 4-1-201(37)). For the assimilation of consignments under certain circumstances to goods on sale or return and the requirement of filing in the case of consignments, see Section 2-326 (A.C.A. § 4-2-326).

The requirements of notice in this section conform closely to the concepts and the language of Section 9-312(3) (A.C.A. § 4-9-312(3)), which should be consulted together with the relevant Comments.

Except in the limited cases of identifiable cash proceeds received on or before delivery of the goods to a buyer, no attempt has been made to provide rules as to perfection of a claim to proceeds of consignments (compare Section 9-306

(A.C.A. § 4-9-306)) or the priority thereof (compare Section 9-312 (A.C.A. § 4-9-312)). It is believed that under many true consignments the consignor acquires a claim for an agreed amount against the consignee at the moment of sale, and does not look to the proceeds of sale. In contrast to the assumption of this Article (Chapter) that rights to proceeds of security interests under Section 9-306 (A.C.A. § 4-9-306) represent the presumed intent of the parties (compare Section 9-203(3) (A.C.A. § 4-9-203(3))), the Article (Chapter) goes on the assumption that if consignors intend to claim the proceeds of sale, they will do so by expressly contracting for them and will perfect their security interests therein.

*Cross References:*

Sections 2-326 (A.C.A. § 4-2-326) and 9-312(3) (A.C.A. § 4-9-312(3)).

*Definitional Cross References:*

"Consignment". Section 1-201(37) (A.C.A. § 4-1-201(37)).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Notification". Section 1-201(26) (A.C.A. § 4-1-201(26)).

"Proceeds". Section 9-306 (A.C.A. § 4-9-306).

"Security interest". Section 1-201(37) (A.C.A. § 4-1-201(37)).

**1972 Official Comment to § 9-201 (A.C.A. § 4-9-201)**

*Prior Uniform Statutory Provisions:* Section 4, Uniform Conditional Sales Act; Section 3, Uniform Trust Receipts Act.

This section states the general validity of a security agreement. In general the security agreement is effective between the parties; it is likewise effective against third parties. Exceptions to this general rule arise where there is a specific provi-

sion in any Article (Chapter) of this Act, for example, where Article 1 (Chapter 1) invalidates a disclaimer of the obligations of good faith, etc. (Section 1-102(3) (A.C.A. § 4-1-102(3))), or this Article (Chapter) subordinates the security interest because it has not been perfected (Section 9-301 (A.C.A. § 4-9-301)) or for other reasons (see Section 9-312 (A.C.A. § 4-9-312) on

priorities) or defeats the security interest where certain types of claimants are involved (for example Section 9-307 (A.C.A. § 4-9-307) on buyers of goods). As pointed out in the Note to Section 9-102 (A.C.A. § 4-9-102), there is no intention that the enactment of this Article (Chapter) should repeal retail installment selling acts or small loan acts. Nor of course are the usury laws of any state repealed. These are mentioned in the text of Section 9-201 (A.C.A. § 4-9-201) as examples of applicable laws, outside this Code entirely, which might invalidate the terms of a security agreement.

*Cross References:*

Sections 1-102(3) (A.C.A. § 4-1-102(3)),

**1972 Official Comment to § 9-202 (A.C.A. § 4-9-202)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

The rights and duties of the parties to a security transaction and of third parties are stated in this Article (Chapter) without reference to the location of "title" to the collateral. Thus the incidents of a security interest which secures the purchase price of goods are the same under this Article (Chapter) whether the secured party appears to have retained title or the debtor appears to have obtained title and then conveyed it or a lien to the secured party. This Article (Chapter) in no way determines which line of interpretation (title theory v. lien theory or retained title v. conveyed title) should be followed in cases where the applicability of some other rule of law depends upon who has title. Thus if a revenue law imposes a tax on the "legal" owner of goods or if a corporation law makes a vote of the stockholders prerequisite to a corporation "giving" a security interest but not if it acquires property "subject" to a security interest, this Article (Chapter) does not attempt to define whether the secured party is a "legal" owner or whether the transaction

9-301 (A.C.A. § 4-9-301), 9-307 (A.C.A. § 4-9-307) and 9-312 (A.C.A. § 4-9-312).

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"gives" a security interest for the purpose of such laws. Other rules of law or the agreement of the parties determine the location of "title" for such purposes.

Petitions for reclamation brought by a secured party in his debtor's insolvency proceedings have often been granted or denied on a title theory: where the secured party has title, reclamation will be granted; where he has "merely a lien", reclamation may be denied. For the treatment of such petitions under this Article (Chapter), see Point 1 of Comment to Section 9-507 (A.C.A. § 4-9-507).

*Cross References:*

Sections 2-401 (A.C.A. § 4-2-401) and 2-507 (A.C.A. § 4-2-507).

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

**1972 Official Comment to § 9-203 (A.C.A. § 4-9-203)\***

*Prior Uniform Statutory Provision:* Section 2, Uniform Trust Receipts Act.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-9-203(1)) states three basic prerequisites to the ex-

istence of a security interest: agreement, value, and collateral. In addition, the agreement must be in writing unless the collateral is in the possession of the secured party (including an agent on his behalf — see Comment 2 to Section 9-305



(A.C.A. § 4-9-305)). When all of these elements exist, the security agreement becomes enforceable between the parties and is said to "attach". Perfection of a security interest (see Section 9-303 (A.C.A. § 4-9-303)) will in many cases depend on the additional step of filing a financing statement (see Section 9-302 (A.C.A. § 4-9-302)) or possession of the collateral (Sections 9-304(1) (A.C.A. § 4-9-304(1)) and 9-305 (A.C.A. § 4-9-305)). Section 9-301 (A.C.A. § 4-9-301) states who will take priority over a security interest which has attached but which has not been perfected. Subsection (2) (A.C.A. § 4-9-203(2)) states a rule of construction under which the security interest, unless postponed by explicit agreement, attaches automatically when the stated events have occurred.

2. As to the type of description of collateral in a written security agreement which will satisfy the requirements of this section, see Section 9-110 (A.C.A. § 4-9-110) and Comment thereto.

In the case of crops growing or to be grown or timber to be cut the best identification is by describing the land, and subsection (1)(a) (A.C.A. § 4-9-203(1)(a)) requires such a description.

3. One purpose of the formal requisites stated in subsection (1)(a) (A.C.A. § 4-9-203(1)(a)) is evidentiary. The requirement of written record minimizes the possibility of future dispute as to the terms of a security agreement and as to what property stands as collateral for the obligation secured. Where the collateral is in the possession of the secured party, the evidentiary need for a written record is much less than where the collateral is in the debtor's possession; customarily, of course, as a matter of business practice the written record will be kept, but, in this Article (Chapter) as at common law, the writing is not a formal requisite. Subsection (1)(a) (A.C.A. § 4-9-203(1)(a)), therefore, dispenses with the written agreement — and thus with signature and description — if the collateral is in the secured party's possession.

4. The definition of "security agreement" (Section 9-105 (A.C.A. § 4-9-105)) is "an agreement which creates or provides for a security interest". Under that definition the requirement of this section that the debtor sign a security agreement is not intended to reject, and does not

reject, the deeply rooted doctrine that a bill of sale although absolute in form may be shown to have been in fact given as security. Under this Article (Chapter) as under prior law a debtor may show by parol evidence that a transfer purporting to be absolute was in fact for security and may then, on payment of the debt, assert his fundamental right to return of the collateral and execution of an acknowledgment of satisfaction.

5. The formal requisite of a writing stated in this section is not only a condition to the enforceability of a security interest against third parties, it is in the nature of a Statute of Frauds. Unless the secured party is in possession of the collateral, his security interest, absent a writing which satisfies paragraph (1)(a) (A.C.A. § 4-9-203(1)(a)) is not enforceable even against the debtor, and cannot be made so on any theory of equitable mortgage or the like. If he has advanced money, he is of course a creditor and, like any creditor, is entitled after judgment to appropriate process to enforce his claim against his debtor's assets; he will not, however, have against his debtor the rights given a secured party by Part 5 of this Article (Chapter) on Default. The theory of equitable mortgage, insofar as it has operated to allow creditors to enforce informal security agreements against debtors, may well have developed as a necessary escape from the elaborate requirements of execution, acknowledgment and the like which the nineteenth century chattel mortgage acts vainly relied on as a deterrent to fraud. Since this Article (Chapter) reduces formal requisites to a minimum, the doctrine is no longer necessary or useful. More harm than good would result from allowing creditors to establish a secured status by parol evidence after they have neglected the simple formality of obtaining a signed writing.

6. Subsection (4) (A.C.A. § 4-9-203(4)) states that the provisions of regulatory statutes covering the field of consumer finance prevail over the provisions of this Article (Chapter) in case of conflict. The second sentence of the subsection is added to make clear that no doctrine of total voidness for illegality is intended: failure to comply with the applicable regulatory statute has whatever effect may be specified in that statute, but no more.

*Cross References:*

Sections 4-208 (A.C.A. § 4-4-208) and 9-113 (A.C.A. § 4-9-113).

Point 1: Section 9-110 (A.C.A. § 4-9-110).

Point 5: Part 5.

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Proceeds". Section 9-306 (A.C.A. § 4-9-306).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

\*This section was amended by Acts 1973, No. 116, § 1 (9-203), to incorporate the 1972 changes to this Uniform Commercial Code section, and by Acts 1985, No. 514, § 7, to incorporate the 1977 changes to this Uniform Commercial Code section.

### 1972 Official Comment to § 9-204 (A.C.A. § 4-9-204)\*

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-9-204(1)) makes clear that a security interest arising by virtue of an after-acquired property clause has equal status with a security interest in collateral in which the debtor has rights at the time value is given under the security agreement. That is to say: the security interest in after-acquired property is not merely an "equitable" interest; no further action by the secured party — such as the taking of a supplemental agreement covering the new collateral — is required. This does not however mean that the interest is proof against subordination or defeat: Section 9-108 (A.C.A. § 4-9-108) should be consulted on when a security interest in after-acquired collateral is not security for antecedent debt, and Section 9-312(3) (A.C.A. § 4-9-312(3)) and (4) (A.C.A. § 4-9-312(4)) on when such a security interest may be subordinated to a conflicting purchase money security interest in the same collateral.

2. This Article (Chapter) accepts the principle of a "continuing general lien". It rejects the doctrine — of which the judicial attitude toward after-acquired property interests was one expression — that there is reason to invalidate as a matter of law what has been variously called the floating charge, the free-handed mortgage and the lien on a shifting stock. This Article (Chapter) validates a security interest in the debtor's existing and future assets, even though (see Section 9-205 (A.C.A. § 4-9-205)) the debtor has liberty

to use or dispose of collateral without being required to account for proceeds or substitute new collateral. (See further, however, Section 9-306 (A.C.A. § 4-9-306) on Proceeds and Comment thereto.)

The widespread nineteenth century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it. This Article (Chapter) decisively rejects it not on the ground that it was wrong in policy but on the ground that it was not effective. In pre-Code law there was a multiplication of security devices designed to avoid the policy: field warehousing, trust receipts, factor's lien acts and so on. The cushion of free assets was not preserved. In almost every state it was possible before the Code for the borrower to give a lien on everything he held or would have. There have no doubt been sufficient economic reasons for the change. This Article (Chapter), in expressly validating the floating charge, merely recognizes an existing state of things. The substantive rules of law set forth in the balance of the Article (Chapter) are designed to achieve the protection of the debtor and the equitable resolution of the conflicting claims of creditors which the old rules no longer give.

Notice that the question of assignment of future accounts is treated like any other



case of after-acquired property: no periodic list of accounts is required by this Act. Where less than all accounts are assigned such a list may of course be necessary to permit identification of the particular accounts assigned.

3. Subsection (1) (A.C.A. § 4-9-204(1)) has been already referred to in connection with after-acquired property. It also serves to validate the so-called "cross-security" clause under which collateral acquired at any time may secure advances whenever made.

4. Subsection (2) (A.C.A. § 4-9-204(2)) limits the operation of the after-acquired property clause against consumers. No such interest can be claimed as additional security in consumer goods (defined in Section 9-109 (A.C.A. § 4-9-109)), except accessions (see Section 9-314 (A.C.A. § 4-9-314)), acquired more than ten days after the giving of value.

5. Under subsection (3) (A.C.A. § 4-9-204(3)) collateral may secure future as well as present advances when the security agreement so provides. At common law and under chattel mortgage statutes there seems to have been a vaguely articulated prejudice against future advance agreements comparable to the prejudice against after-acquired property interests. Although only a very few jurisdictions went to the length of invalidating interests claimed by virtue of future advances, judicial limitations severely restricted the usefulness of such arrangements. A common limitation was that an interest claimed in collateral existing at the time the security transaction was entered into for advances made thereafter was good only to the extent that the original security agreement specified the amount of such later advances and even the times at which they should be made. In line with the policy of this Article (Chapter) toward after-acquired property interests this subsection validates the future advance interest, provided only that the obligation be covered by the security agreement.

The effect of after-acquired property and future advance clauses in the security agreement should not be confused with the use of financing statements in notice filing. The references to after-acquired property clauses and future advance clauses in Section 9-204 (A.C.A. § 4-9-204) are limited to security agreements. This section follows Section 9-203 (A.C.A.

§ 4-9-203), the section requiring a written security agreement, and its purpose is to make clear that confirmatory agreements are not necessary where the basic agreement has the clauses mentioned. This section has no reference to the operation of financing statements. The filing of a financing statement is effective to perfect security interests as to which the other required elements for perfection exist, whether the security agreement involved is one existing at the date of filing with an after-acquired property clause or a future advance clause, or whether the applicable security agreement is executed later. Indeed, Section 9-402(1) (A.C.A. § 4-9-402(1)) expressly contemplates that a financing statement may be filed when there is no security agreement. There is no need to refer to after-acquired property or future advances in the financing statement.

As in the case of interests in after-acquired collateral, a security interest based on future advances may be subordinated to conflicting interests in the same collateral. See Sections 9-301(4) (A.C.A. § 4-9-301(4)); 9-307(3) (A.C.A. § 4-9-307(3)); 9-312(3) (A.C.A. § 4-9-312(3)), (4) (A.C.A. § 4-9-312(4)), and (7) (A.C.A. § 4-9-312(7)).

#### *Cross References:*

Point 1: Sections 9-108 (A.C.A. § 4-9-108) and 9-312 (A.C.A. § 4-9-312).

Point 2: Sections 9-205 (A.C.A. § 4-9-205) and 9-306 (A.C.A. § 4-9-306).

Point 4: Sections 9-109 (A.C.A. § 4-9-109) and 9-314 (A.C.A. § 4-9-314).

Point 5: Sections 9-301(4) (A.C.A. § 4-9-301(4)); 9-307(3) (A.C.A. § 4-9-307(3)); 9-312(3) (A.C.A. § 4-9-312(3)), (4) (A.C.A. § 4-9-312(4)), and (7) (A.C.A. § 4-9-312(7)).

#### *Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Consumer goods". Section 9-109 (A.C.A. § 4-9-109).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Pursuant to commitment". Section 9-105 (A.C.A. § 4-9-105).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

\*This section was amended by Acts 1973, No. 116, § 1 (9-204), to incorporate the 1972 changes to this Uniform Commercial Code section, and by Acts 1983, No. 561, § 1 to change the language in subsection (2) from "(10) days" to "(21) days", making the language different from this uniform act section.

### 1972 Official Comment to § 9-205 (A.C.A. § 4-9-205)\*

*Prior Uniform Statutory Provision:* None.

#### *Purposes:*

1. This Article (Chapter) expressly validates the floating charge or lien on a shifting stock. (See Sections 9-201 (A.C.A. § 4-9-201), 9-204 (A.C.A. § 4-9-204), and Comment to Section 9-204 (A.C.A. § 4-9-204).) This section provides that a security interest is not invalid or fraudulent by reason of liberty in the debtor to dispose of the collateral without being required to account for proceeds or substitute new collateral. It repeals the rule of *Benedict v. Ratner*, 268 U.S. 353, 45 S.Ct. 566, 69 L.Ed. 991 (1925), and other cases which held such arrangements void as a matter of law because the debtor was given unfettered dominion or control over the collateral. The principle effect of the *Benedict* rule has been, not to discourage or eliminate security transactions in inventory and accounts receivable — on the contrary such transactions have vastly increased in volume — but rather to force financing arrangements in this field toward a self-liquidating basis. Furthermore, several lower court cases drew implications from Justice Brandeis' opinion in *Benedict v. Ratner* which required lenders operating in this field to observe a number of needless and costly formalities: for example it was thought necessary for the debtor to make daily remittances to the lender of all collections received, even though the amount remitted is immediately returned to the debtor in order to keep the loan at an agreed level.

2. The *Benedict* rule was, in the accounts receivable field, repealed in many of the state accounts receivable statutes enacted after 1943, and, in the inventory field, by some of the factor's lien statutes.

(*Benedict v. Ratner* purported to state the law of New York and not a rule of federal bankruptcy law. Since its acceptance is a matter of state law, it can of course be rejected by state statute.)

3. The requirement of "policing" is the substance of the *Benedict* rule. While this section repeals *Benedict* in matters of form, the filing requirements (Section 9-302 (A.C.A. § 4-9-302)) give other creditors the opportunity to ascertain from public sources whether property of their debtor or prospective debtor is subject to secured claims, and the provisions about proceeds (Section 9-306(4) (A.C.A. § 4-9-306(4))) enable creditors to claim collections which were made by the debtor more than 10-days before insolvency proceedings and commingled or deposited in a bank account before institution of the insolvency proceedings. The repeal of the *Benedict* rule under this section must be read in the light of these provisions.

4. Other decisions reaching results like that in the *Benedict* case, but relating to other aspects of dominion (of which *Lee v. State Bank & Trust Co.*, 54 F.2d 518 (2d Cir. 1931), is an example) are likewise rejected.

5. Nothing in Section 9-205 (A.C.A. § 4-9-205) prevents such "policing" or dominion as the secured party and the debtor may agree upon; business and not legal reasons will determine the extent to which strict accountability, segregation of collections, daily reports and the like will be employed.

6. The last sentence is added to make clear that the section does not mean that the holder of an unfiled security interest, whose perfection depends on possession of the collateral by the secured party or by a



bailee (such as a field warehouseman), can allow the debtor access to and control over the goods without thereby losing his perfected interest. The common law rules on the degree and extent of possession which are necessary to perfect a pledge interest or to constitute a valid field warehouse are not relaxed by this or any other section of this Article (Chapter).

*Cross References:*

Point 1: Sections 9-201 (A.C.A. § 4-9-201) and 9-204 (A.C.A. § 4-9-204).

Point 3: Sections 9-302 (A.C.A. § 4-9-302) and 9-306(4) (A.C.A. § 4-9-306(4)).

Point 6: Sections 9-304 (A.C.A. § 4-9-304) and 9-305 (A.C.A. § 4-9-305).

*Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Proceeds". Section 9-306 (A.C.A. § 4-9-306).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-205), to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-206 (A.C.A. § 4-9-206)\***

*Prior Uniform Statutory Provision:* Section 2, Uniform Conditional Sales Act.

*Purposes:*

1. Clauses are frequently inserted in installment purchase contracts under which the conditional vendee agrees not to assert defenses against an assignee of the contract. These clauses have led to litigation and their present status under the case law is in confusion. In some jurisdictions they have been held void as attempts to create negotiable instruments outside the framework of Article 3 (Chapter 3) or on grounds of public policy; in others they have been allowed to operate to cut off at least defenses based on breach of warranty. Under subsection (1) (A.C.A. § 4-9-206(1)) such clauses in a security agreement are validated outside the consumer field, but only as to defenses which could be cut off if a negotiable instrument were used. This limitation is important since if the clauses were allowed to have full effect as typically drafted, they would operate to cut off real as well as personal defenses. The execution of a negotiable note in connection with a security agreement is given like effect as the execution of an agreement containing a waiver of defense clause. The same rules are made applicable to leases as to security agreements,

whether or not the lease is intended as security.

2. This Article (Chapter) takes no position on the controversial question whether a buyer of consumer goods may effectively waive defenses by contractual clause or by execution of a negotiable note. In some states such waivers have been invalidated by statute. In other states the course of judicial decision has rendered them ineffective or unreliable — courts have found that the assignee is not protected against the buyer's defense by a clause in the contract or that the holder of a note, by reason of his too close connection with the underlying transaction, does not have the rights of a holder in due course. This Article (Chapter) neither adopts nor rejects the approach taken in such statutes and decisions, except that the validation of waivers in subsection (1) (A.C.A. § 4-9-206(1)) is expressly made "subject to any statute or decision" which may restrict the waiver's effectiveness in the case of a buyer of consumer goods.

3. Subsection (2) (A.C.A. § 4-9-206(2)) makes clear, as did Section 2 of the Uniform Conditional Sales Act, that purchase money security transactions are sales, and warranty rules for sales are applicable. It also prevents a buyer from inadvertently abandoning his warranties by a

"no warranties" term in the security agreement when warranties have already been created under the sales arrangement. Where the sales arrangement and the purchase money security transaction are evidenced by only one writing, that writing may disclaim, limit or modify warranties to the extent permitted by Article 2 (Chapter 2).

*Cross References:*

Point 1: Section 3-305 (A.C.A. § 4-3-305).

Point 2: Section 9-203(2) (A.C.A. § 4-9-203(2)).

Point 3: Sections 2-102 (A.C.A. § 4-2-102) and 2-316 (A.C.A. § 4-2-316).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Consumer goods". Section 9-109 (A.C.A. § 4-9-109).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Holder in due course". Sections 3-302 (A.C.A. § 4-3-302) and 9-105 (A.C.A. § 4-9-105).

"Negotiable instrument". Section 3-104 (A.C.A. § 4-3-104).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Purchase money security interest". Section 9-107 (A.C.A. § 4-9-107).

"Sale". Sections 2-106 (A.C.A. § 4-2-106) and 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

\*This section was amended by Acts 1967, No. 303, § 30, to incorporate the 1962 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-207 (A.C.A. § 4-9-207)\***

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-9-207(1)) states the duty to preserve collateral imposed on a pledge at common law. See Restatement of Security, §§ 17, 18. In many cases a secured party having collateral in his possession may satisfy this duty by notifying the debtor of any act which must be taken and allowing the debtor to perform such act himself. If the secured party himself takes action, his reasonable expenses may be added to the secured obligation.

Under Section 1-102(3) (A.C.A. § 4-1-102(3)) the duty to exercise reasonable care may not be disclaimed by agreement, although under that section the parties remain free to determine by agreement, in any manner not manifestly unreasonable, what shall constitute reasonable care in a particular case.

2. Subsection (2) (A.C.A. § 4-9-207(2)) states rules, which follow common law precedents, and which apply, unless there is agreement otherwise, in typical situations during the period while the secured party is in possession of the collateral.

3. The right of a secured party holding instruments or documents to have them indorsed or transferred to him or his order is dealt with in the relevant sections of Articles 3 (Chapter 3) (Commercial Paper), 7 (Chapter 7) (Warehouse Receipts, Bills of Lading and Other Documents) and 8 (Chapter 8) (Investment Securities). (Sections 3-201 (A.C.A. § 4-3-201), 7-506 (A.C.A. § 4-7-506), 8-307 (A.C.A. § 4-8-307).)

4. This section applies when the secured party has possession of the collateral before default as a pledgee, and also when he has taken possession of the collateral after default. See Section 9-501(1) (A.C.A. § 4-9-501(1)) and (2) (A.C.A. § 4-9-501(2)). Subsection (4) (A.C.A. § 4-9-207(4)) permits operation of the collateral in the circumstances stated, and subsection (2)(a) (A.C.A. § 4-9-207(2)(a)) authorizes payment of or provision for expenses of such operation. Agreements providing for such operation are common in trust indentures securing corporate bonds and are particularly important when the collateral is a going business. Such an agreement cannot of course disclaim the duty of



care established by subsection (1) (A.C.A. § 4-9-207(1)), nor can it waive or modify the rights of the debtor contrary to Section 9-501(3) (A.C.A. § 4-9-501(3)).

*Cross References:*

Point 1: Section 1-102(3) (A.C.A. § 4-1-102(3)).

Point 3: Sections 3-201 (A.C.A. § 4-3-201), 7-506 (A.C.A. § 4-7-506) and 8-307 (A.C.A. § 4-8-307).

Point 4: Section 9-501(2) (A.C.A. § 4-9-501(2)) and Part 5.

*Definitional Cross References:*

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Instrument". Section 9-105 (A.C.A. § 4-9-105).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1, to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-208 (A.C.A. § 4-9-208)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. To provide a procedure whereby a debtor may obtain from the secured party a statement of the amount due on the obligation and in some cases a statement of the collateral.

2. The financing statement required to be filed under this Article (Chapter) (see Section 9-402 (A.C.A. § 4-9-402)) may disclose only that a secured party may have a security interest in specified types of collateral owned by the debtor. Unless a copy of the security agreement itself is filed as the financing statement third parties are told neither the amount of the obligation secured nor which particular assets are covered. Since subsequent creditors and purchasers may legitimately need more detailed information, it is necessary to provide a procedure under which the secured party will be required to make disclosure. On the other hand, the secured party should not be under a duty to disclose details of business operations to any casual inquirer or competitor who asks for them. This section gives the right to demand disclosure only to the debtor, who will typically request a statement in connection with negotiations with subsequent creditors and purchasers, or for the purpose of establishing his credit standing and proving which of his assets are free of the security interest. The secured party is

further protected against onerous requests by the provisions that he need furnish a statement of collateral only when his own records identify the collateral and that if he claims all of a particular type of collateral owned by the debtor he is not required to approve an itemized list.

*Cross Reference:*

Point 2: Section 9-402 (A.C.A. § 4-9-402).

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Know". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Receive". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

## 1972 Official Comment to § 9-301 (A.C.A. § 4-9-301)\*

*Prior Uniform Statutory Provision:* Sections 8(2) and 9(2)(b), Uniform Trust Receipts Act; Section 5, Uniform Conditional Sales Act.

*Purposes:*

1. This section (A.C.A. § 4-9-301) lists the classes of persons who take priority over an unperfected security interest. As in Section 60 of the Federal Bankruptcy Act, the term "perfected" is used to describe a security interest in personal property which cannot be defeated in insolvency proceedings or in general by creditors. A security interest is "perfected" when the secured party has taken whatever steps are necessary to give him such an interest. These steps are explained in the five following sections (9-302 through 9-306 (A.C.A. §§ 4-9-302 through 4-9-306)).

2. Section 9-312 (A.C.A. § 4-9-312) states general rules for the determination of priorities among conflicting security interests and in addition refers to other sections which state special rules of priority in a variety of situations. The interests given priority under Section 9-312 (A.C.A. § 4-9-312) and the other sections therein cited take such priority in general even over a perfected security interest. A fortiori they take priority over an unperfected security interest, and paragraph (1)(a) (A.C.A. § 4-9-301(1)(a)) of this section so states.

3. Paragraph (1)(b) (A.C.A. § 4-9-301(1)(b)) provides that an unperfected security interest is subordinate to the rights of lien creditors. The section (A.C.A. § 4-9-301) rejects the rule applied in many jurisdictions in pre-Code law that an unperfected security interest is subordinated to all creditors, but requires the lien obtained by legal proceedings to attach to the collateral before the security interest is perfected. The section (A.C.A. § 4-9-301) subordinates the unperfected security interest but does not subordinate the secured debt to the lien.

4. Paragraphs (1)(c) (A.C.A. § 4-9-301(1)(c)) and (1)(d) (A.C.A. § 4-9-301(1)(d)) deal with purchasers (other than secured parties) of collateral who would take subject to a perfected security interest but who are by these subsections given priority over an unperfected secu-

rity interest. In the cases of goods and of intangibles of the type whose transfer is effected by physical delivery of the representative piece of paper (instruments, documents and chattel paper) the purchaser who takes priority must both give value and receive delivery of the collateral without knowledge of the existing security interest and before perfection (paragraph (1)(c) (A.C.A. § 4-9-301(1)(c))). Thus even if the purchaser gave value without knowledge and before perfection, he would take subject to the security interest if perfection occurred before physical delivery of the collateral to him. The paragraph (1)(c) (A.C.A. § 4-9-301(1)(c)) rule is obviously not appropriate where the collateral consists of intangibles and there is no representative piece of paper whose physical delivery is the only or the customary method of transfer. Therefore with respect to such intangibles (accounts and general intangibles), paragraph (1)(d) (A.C.A. § 4-9-301(1)(d)) gives priority to any transferee who has given value without knowledge and before perfection of the security interest.

The term "buyer in ordinary course of business" referred to in paragraph (1)(c) (A.C.A. § 4-9-301(1)(c)) is defined in Section 1-201(9) (A.C.A. § 4-1-201(9)).

Other secured parties are excluded from paragraphs (1)(c) (A.C.A. § 4-9-301(1)(c)) and (1)(d) (A.C.A. § 4-9-301(1)(d)) because their priorities are covered in Section 9-312 (A.C.A. § 4-9-312) (see point 2 of this Comment).

5. Except to the extent provided in subsection (2) (A.C.A. § 4-9-301(2)), this Article (Chapter) (A.C.A. § 4-9-101 et seq.) does not permit a secured party to file or take possession after another interest has received priority under subsection (1) (A.C.A. § 4-9-301(1)) and thereby protect himself against the intervening interest.

A few chattel mortgage statutes did have grace periods, i.e., a filing within x days after the mortgage was given related back to the day the mortgage was given. The Uniform Conditional Sales Act had a ten-day period which cut off all intervening interests. The Uniform Trust Receipts Act had a thirty-day period but did not cut off the interest of a purchaser who took delivery before the filing.



Subsection (2) (A.C.A. § 4-9-301(2)) gives a grace period for perfection by filing as to purchase money security interests only (that term is defined in Section 9-107 (A.C.A. § 4-9-107)). The grace period runs for ten days after the debtor receives possession of the collateral but operates to cut off only the interests of intervening lien creditors or bulk purchasers.

6. Subsection (3) (A.C.A. § 4-9-301(3)) defines "lien creditor", following in substance the provisions of the Uniform Trust Receipts Act.

7. Subsection (4) (A.C.A. § 4-9-301(4)) deals with the question whether advances under an existing security interest in collateral, made after rights of lien creditors have attached to that collateral, will take precedence over rights of lien creditors. See related problems in Sections 9-307(3) (A.C.A. § 4-9-307(3)) and 9-312(7) (A.C.A. § 4-9-312(7)). In this section (A.C.A. § 4-9-301), because of the impact of the rule chosen on the question whether the security interest for future advances is "protected" under Sections 6323(c)(2) and (d) of the Internal Revenue Code as amended by the Federal Tax Lien Act of 1966, the priority of the security interest for future advances over a judgment lien is made absolute for 45 days regardless of knowledge of the secured party concerning the judgment lien. If, however, the advance is made after the 45 days, the advance will not have priority unless it was made or committed without knowledge of the lien obtained by legal proceedings. The importance of the rule chosen for actual conflicts between secured parties making subsequent advances and judgment lien creditors may not be great; but the rule chosen for the first 45 days is important in effectuating the intent of the Federal Tax Lien Act of 1966.

8. The word "only" in subsection (4) (A.C.A. § 4-9-301(4)) is limited in its effect to the lien creditor's subjection to the specified advances. It does not limit the lien creditor's subjection to whatever other rights the secured party may have by contract or law, e.g., the right to interest before or after the attachment of the judgment lien to the collateral or the right to foreclosure expenses or other collection expenses. See PEB Commentary No. 2, dated March 10, 1990.

9. There is no conflict between the principle of § 9-301(1) (A.C.A. § 4-9-301(1))

and the "shelter principle," which is applied at several points in the statute, but is most explicitly stated in § 2-403(1) (A.C.A. § 4-2-403(1)): "A purchaser of goods acquires all title which his transferor had..."

Although § 9-301(1) (A.C.A. § 4-9-301(1)) fails to state the shelter principle expressly, that principle is applicable where a person who had met the conditions for prevailing over an unperfected security interest transfers his right to another person after the security interest is perfected. See PEB Commentary No. 6, dated March 10, 1990.

The rules for subordination of unperfected security interests have a purpose—in common with similar rules in all filing and recording systems—to impose sanctions for not adhering to filing or recording requirements. Such rules are necessary to make the system effective and enforce the policy against secret liens. The shelter principle recognizes that when a person in a protected class transfers his right after the security interest has been perfected, the right will be diminished in value unless the sanction is continued. The sanction imposed by § 9-301(1) (A.C.A. § 4-9-301(1)) is that members of protected classes take free of an unperfected security interest. That sanction should be continued to protect transferees from those members in order to fulfill the purpose of the section.

#### *Cross References:*

Section 9-312 (A.C.A. § 4-9-312).

Point 1: Sections 9-302 through 9-306 (A.C.A. §§ 4-9-302 through 4-9-306).

Point 7: Sections 9-204 (A.C.A. § 4-9-204), 9-307(3) (A.C.A. § 4-9-307(3)) and 9-312(7) (A.C.A. § 4-9-312(7)).

#### *Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Buyer in ordinary course of business". Section 1-201 (A.C.A. § 4-1-201).

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 9-105 (A.C.A. § 4-9-105).

"General intangibles". Section 9-106 (A.C.A. § 4-9-106).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Instrument". Section 9-105 (A.C.A. § 4-9-105).

"Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase money security interest". Section 9-107 (A.C.A. § 4-9-107).

"Pursuant to commitment". Section 9-105 (A.C.A. § 4-9-105).

"Representative". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-301), to incorporate the 1972 changes to this Uniform Commercial Code section, and by Acts 1983, No. 561, § 2, to change the language of "ten days" in subsection (2) to "twenty-one (21) days", making the language different from the Uniform Act section.

### 1972 Official Comment to § 9-302 (A.C.A. § 4-9-302)\*

*Prior Uniform Statutory Provision:* Section 5, Uniform Conditional Sales Act; Section 8, Uniform Trust Receipts Act.

#### *Purposes:*

1. Subsection (1) (A.C.A. § 4-9-302(1)) states the general rule that to perfect a security interest under this Article (Chapter) a financing statement must be filed. Paragraphs (1)(a) through (1)(g) (A.C.A. § 4-9-302(1)(a) through 4-9-302(1)(g)) exempt from the filing requirement the transactions described. Subsection (3) (A.C.A. § 4-9-302(3)) further sets out certain transactions to which the filing provisions of this Article (Chapter) do not apply, but it does not defer to another state statute on the filing of inventory security interests. The cases recognized are those where suitable alternative systems for giving public notice of a security interest are available. Subsection (4) (A.C.A. § 4-9-302(4)) states the consequences of such other form of notice.

Section 9-303 (A.C.A. § 4-9-303) states the time when a security interest is perfected by filing or otherwise. Part 4 of the Article (Chapter) deals with the mechanics of filing: place of filing, form of financing statement and so on.

2. As at common law, there is no requirement of filing when the secured party has possession of the collateral in a pledge transaction (paragraph (1)(a) (A.C.A. § 4-9-302(1)(a))). Section 9-305 (A.C.A. § 4-9-305) should be consulted on what collateral may be pledged and on the requirements of possession.

3. Under this Article (Chapter), as under the Uniform Trust Receipts Act, filing is not effective to perfect a security interest in instruments. See Section 9-304(1) (A.C.A. § 4-9-304(1)).

4. Where goods subject to a security interest are left in the debtor's possession, the only permanent exception from the general filing requirement is that stated in paragraph (1)(d) (A.C.A. § 4-9-302(1)(d)): purchase money security interests in consumer goods. For temporary exceptions, see Sections 9-304(5)(a) (A.C.A. § 4-9-304(5)(a)) and 9-306 (A.C.A. § 4-9-306).

In many jurisdictions under prior law security interests in consumer goods under conditional sale or bailment leases were not subject to filing requirements. Paragraph (1)(d) (A.C.A. § 4-9-302(1)(d)) follows the policy of those jurisdictions. The paragraph changes prior law in jurisdictions where all conditional sales and bailment leases were subject to a filing requirement, except that filing is required for purchase money security interests in consumer fixtures to attain priority under Section 9-313 (A.C.A. § 4-9-313) against real estate interests.

Although the security interests described in paragraph (1)(d) (A.C.A. § 4-9-302(1)(d)) are perfected without filing, Section 9-307(2) (A.C.A. § 4-9-307(2)) provides that unless a financing statement is filed certain buyers may take free of the security interest even though perfected.



See that section and the Comment thereto.

On filing for security interests in motor vehicles under certificate of title laws see subsection (3) (A.C.A. § 4-9-302(3)) of this section.

5. A financing statement must be filed to perfect a security interest in accounts except for the transactions described in paragraphs (1)(e) (A.C.A. § 4-9-302(1)(e)) and (g) (A.C.A. § 4-9-302(1)(g)). It should be noted that this Article (Chapter) applies to sales of accounts and chattel paper as well as to transfers thereof for security (Section 9-102(1)(b) (A.C.A. § 4-9-102(1)(b))); the filing requirement of this section applies both to sales and to transfers thereof for security. In this respect this Article (Chapter) follows many of the pre-Code statutes regulating assignments of accounts receivable.

Over forty jurisdictions had enacted accounts receivable statutes. About half of these statutes required filing to protect or perfect assignments; of the remainder, one was a so-called "bookmarking" statute and the others validated assignments without filing. This Article (Chapter) adopts the filing requirement, on the theory that there is no valid reason why public notice is less appropriate for assignments of accounts than for any other type of nonpossessory interest. Section 9-305 (A.C.A. § 4-9-305), furthermore, excludes accounts from the types of collateral which may be the subject of a possessory security interest: filing is thus the only means of perfection contemplated by this Article (Chapter). See Section 9-306 (A.C.A. § 4-9-306) on accounts as proceeds.

The purpose of the subsection (1)(e) (A.C.A. § 4-9-302(1)(e)) exemption is to have from ex post facto invalidation casual or isolated assignments: some accounts receivable statutes were so broadly drafted that all assignments, whatever their character or purpose, fell within their filing provisions. Under such statutes many assignments which no one would think of filing might have been subject to invalidation. The paragraph (1)(e) (A.C.A. § 4-9-302(1)(e)) exemption goes to that type of assignment. Any person who regularly takes assignments of any debtor's accounts should file. In this connection Section 9-104(f) (A.C.A. § 4-9-104(f)) which excludes certain transfers of

accounts from the Article (Chapter) should be consulted.

Assignments of interests in trusts and estates are not required to be filed because they are often not thought of as collateral comparable to the types dealt with by this Article (Chapter). Assignments for the benefit of creditors are not required to be filed because they are not financing transactions and the debtor will not ordinarily be engaging in further credit transaction.

6. With respect to the paragraph (1)(f) (A.C.A. § 4-9-302(1)(f)) exemptions, see the sections cited therein and Comments thereto.

7. The following example will explain the operation of subsection (2) (A.C.A. § 4-9-302(2)): Buyer buys goods from Seller who retains a security interest in them which he perfects. Seller assigns the perfected security interest to X. The security interest, in X's hands and without further steps on his part, continues perfected against Buyer's transferees and creditors. If, however, the assignment from Seller to X was itself intended for security (or was a sale of accounts or chattel paper), X must take whatever steps may be required for perfection in order to be protected against Seller's transferees and creditors.

8. Subsection (3) (A.C.A. § 4-9-302(3)) exempts from the filing provisions of this Article (Chapter) transactions as to which an adequate system of filing, state or federal, has been set up outside this Article (Chapter) and subsection (4) (A.C.A. § 4-9-302(4)) makes clear that when such a system exists perfection of a relevant security interest can be had only through compliance with that system (i.e., filing under this Article (Chapter) is not a permissible alternative).

Examples of the type of federal statute referred to in paragraph (3)(a) (A.C.A. § 4-9-302(3)(a)) are the provisions of 17 U.S.C. §§ 28, 30 (copyrights), 49 U.S.C. § 1403 (aircraft), 49 U.S.C. § 20(c) (railroads). The Assignment of Claims Act of 1940, as amended, provides for notice to contracting and disbursing officers and to sureties on bonds but does not establish a national filing system and therefore is not within the scope of paragraph (3)(a) (A.C.A. § 4-9-302(3)(a)). An assignee of a claim against the United States, who must of course comply with the Assignment of Claims Act, must also file under

this Article (Chapter) in order to perfect his security interest against creditors and transferees of his assignor.

Some states have enacted central filing statutes with respect to security transactions in kinds of property which are of special importance in the local economy. Subsection (3) (A.C.A. § 4-9-302(3)) adopts such statutes as the appropriate filing system for such property.

In addition to such central filing statutes many states have enacted certificate of title laws covering motor vehicles and the like. Subsection (3) (A.C.A. § 4-9-302(3)) exempts transactions covered by such laws from the filing requirements of this Article (Chapter).

For a discussion of the operation of state motor vehicle certificate of title laws in interstate contexts, see Comment 4 to Section 9-103 (A.C.A. § 4-9-103).

9. Perfection of a security interest under a state or federal statute of the type referred to in subsection (3) (A.C.A. § 4-9-302(3)) has all the consequences of perfection under the provisions of this Article (Chapter). Subsection (4) (A.C.A. § 4-9-302(4)).

*Cross References:*

Point 1: Section 9-303 (A.C.A. § 4-9-303) and Part 4.

Point 2: Section 9-305 (A.C.A. § 4-9-305).

Point 3: Section 9-304(1) (A.C.A. § 4-9-304(1)).

Point 4: Section 9-307(2) (A.C.A. § 4-9-307(2)).

Point 5: Sections 9-102(1)(b) (A.C.A. § 4-9-102(1)(b)), 9-104(f) (A.C.A. § 4-9-104(f)) and 9-305 (A.C.A. § 4-9-305).

Point 6: Sections 4-208 (A.C.A. § 4-4-208) and 9-113 (A.C.A. § 4-9-113).

*Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Consumer goods". Section 9-109 (A.C.A. § 4-9-109).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Delivery". Section 1-201 (A.C.A. § 4-1-201).

"Document". Section 9-105 (A.C.A. § 4-9-105).

"Equipment". Section 9-109 (A.C.A. § 4-9-109).

"Fixture". Section 9-313 (A.C.A. § 4-9-313).

"Fixture filing". Section 9-313 (A.C.A. § 4-9-313).

"Instrument". Section 9-105 (A.C.A. § 4-9-105).

"Inventory". Section 9-109 (A.C.A. § 4-9-109).

"Proceeds". Section 9-306 (A.C.A. § 4-9-306).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Purchase money security interest". Section 9-107 (A.C.A. § 4-9-107).

"Sale". Sections 2-106 (A.C.A. § 4-2-106) and 9-105 (A.C.A. § 4-9-105).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-302), to incorporate the 1972 changes to this Uniform Commercial Code section. It was also amended by Acts 1983, No. 561, § 3, which changed the time period in subsection (b) from "a ten day period" to "a twenty-one (21) day period". It was also amended by Acts 1985, No. 514, § 8, to incorporate the 1977 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-303 (A.C.A. § 4-9-303)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. The term "attach" is used in this Article (Chapter) to describe the point at which property becomes subject to a security interest. The requisites for attachment are stated in Section 9-203 (A.C.A. § 4-9-203). When it attaches a security

interest may be either perfected or unperfected: "Perfected" means that the secured party has taken all the steps required by this Article (Chapter) as specified in the several sections listed in subsection (1) (A.C.A. § 4-9-303(1)). A perfected security interest may still be or become subordinate to other interests (see



Section 9-312 (A.C.A. § 4-9-312)) but in general after perfection the secured party is protected against creditors and transferees of the debtor and in particular against any representative of creditors in insolvency proceedings instituted by or against the debtor. Subsection (1) (A.C.A. § 4-9-303(1)) states the truism that the time of perfection is when the security interest has attached and any necessary steps for perfection (such as taking possession or filing) have been taken. If the steps for perfection have been taken in advance (as when the secured party files a financing statement before giving value or before the debtor acquires rights in the collateral), then the interest is perfected automatically when it attaches.

2. The following example will illustrate the operation of subsection (2) (A.C.A. § 4-9-303(2)): A bank which has issued a letter of credit honors drafts drawn under the credit and receives possession of the negotiable bill of lading covering the goods shipped. Under Sections 9-304(2) (A.C.A. § 4-9-304(2)) and 9-305 (A.C.A. § 4-9-305) the bank now has a perfected security interest in the document and the goods. The bank releases the bill of lading to the debtor for the purpose of procuring the goods from the carrier and selling them. Under Section 9-304(5) (A.C.A. § 4-9-304(5)) the bank continues to have a perfected security interest in the document and goods for 21 days. The bank files before the expiration of the 21-day period. Its security interest now continues perfected for as long as the filing is good. The goods are sold by the debtor. The bank continues to have a security interest in the proceeds of the sale to the extent stated in Section 9-306 (A.C.A. § 4-9-306).

If the successive stages of the bank's security interest succeed each other without an intervening gap, the security inter-

est is "continuously perfected" and the date of perfection is when the interest first became perfected (i.e., in the example given, when the bank received possession of the bill of lading against honor of the drafts). If, however, there is a gap between stages — for example, if the bank does not file until after the expiration of the 21-day period specified in Section 9-304(5) (A.C.A. § 4-9-304(5)), the collateral still being in the debtor's possession — then, the chain being broken, the perfection is no longer continuous. The date of perfection would now be the date of filing (after expiration of the 21-day period); the bank's interest might now become subject to attack under Section 60 of the Federal Bankruptcy Act and would be subject to any interests arising during the gap period which under Section 9-301 (A.C.A. § 4-9-301) take priority over an unperfected security interest.

The rule of subsection (2) (A.C.A. § 4-9-303(2)) would also apply to the case of collateral brought into this state subject to a security interest which became perfected in another state or jurisdiction. See Section 9-103(1)(d) (A.C.A. § 4-9-103(1)(d)).

#### *Cross References:*

Sections 9-302 (A.C.A. § 4-9-302), 9-304 (A.C.A. § 4-9-304), 9-305 (A.C.A. § 4-9-305) and 9-306 (A.C.A. § 4-9-306).

Point 1: Sections 9-204 (A.C.A. § 4-9-204) and 9-312 (A.C.A. § 4-9-312).

Point 2: Sections 9-103(1)(d) (A.C.A. § 4-9-103(1)(d)) and 9-301 (A.C.A. § 4-9-301).

#### *Definitional Cross References:*

"Attach". Section 9-203 (A.C.A. § 4-9-203).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

### **1972 Official Comment to § 9-304 (A.C.A. § 4-9-304)\***

*Prior Uniform Statutory Provision:* Sections 3 and 8(1), Uniform Trust Receipts Act.

#### *Purposes:*

1. For most types of property, filing and taking possession are alternative methods of perfection. For some types of intangibles (i.e., accounts and general intangibles) filing is the only available method

(see Section 9-305 (A.C.A. § 4-9-305) and point 1 of Comment thereto). With respect to instruments subsection (1) (A.C.A. § 4-9-304(1)) provides that, except for the cases of "temporary perfection" covered in subsections (4) (A.C.A. § 4-9-304(4)) and (5) (A.C.A. § 4-9-304(5)), taking possession is the only available method; this provision follows the Uniform Trust Re-

ceipts Act. The rule is based on the thought that where the collateral consists of instruments, it is universal practice for the secured party to take possession of them in pledge; any surrender of possession to the debtor is for a short time; therefore it would be unwise to provide the alternative of perfection for a long period by filing which, since it in no way corresponds with commercial practice, would serve no useful purpose.

For similar reasons, filing is not permitted as to money. Perfection of security interests in certificated securities, which are covered by the definition of instruments, is governed by Section 8-321 (A.C.A. § 4-8-321) and, therefore, excluded from this section.

Subsection (1) (A.C.A. § 4-9-304(1)) further provides that filing is available as a method of perfection for security interests in chattel paper and negotiable documents, which also come within Section 9-305 (A.C.A. § 4-9-305) on perfection by possession. Chattel paper is sometimes delivered to the assignee, sometimes left in the hands of the assignor for collection; subsection (1) (A.C.A. § 4-9-304(1)) allows the assignee to perfect his interest by filing in the latter case. Negotiable documents may be, and usually are, delivered to the secured party; subsection (1) (A.C.A. § 4-9-304(1)) follows the Uniform Trust Receipts Act in allowing filing as an alternative method of perfection. Perfection of an interest in goods through a non-negotiable document is covered in subsection (3) (A.C.A. § 4-9-304(3)).

2. Subsection (2) (A.C.A. § 4-9-304(2)), following prior law and consistently with the provisions of Article 7 (Chapter 7), takes the position that, so long as a negotiable document covering goods is outstanding, title to the goods is, so to say, locked up in the document and the proper way of dealing with such goods is through the document. Perfection therefore is to be made with respect to the document and, when made, automatically carries over to the goods. Any interest perfected directly in the goods while the document is outstanding (for example, a chattel mortgage type of security interest on goods in a warehouse) is subordinated to an outstanding negotiable document.

3. Subsection (3) (A.C.A. § 4-9-304(3)) takes a different approach to the problem of goods covered by a non-negotiable doc-

ument or otherwise in the possession of a bailee who has not issued a negotiable document. Here title to the goods is not looked on as being locked up in the document and the secured party may perfect his interest directly in the goods by filing as to them. The subsection states two other methods of perfection: issuance of the document in the secured party's name (as consignee of a straight bill of lading or the person to whom delivery would be made under a non-negotiable warehouse receipt) and receipt of notification of the secured party's interest by the bailee which, under Section 9-305 (A.C.A. § 4-9-305), is looked on as equivalent to taking possession by the secured party.

4. Subsections (4) (A.C.A. § 4-9-304(4)) and (5) (A.C.A. § 4-9-304(5)) follow the Uniform Trust Receipts Act in giving perfected status to security interests in instruments (other than certificated securities, which are governed by Section 8-321 (A.C.A. § 4-8-321)) and documents for a short period although there has been no filing and the collateral is in the debtor's possession. The period of 21 days is chosen to conform to the provisions of Section 60 of the Federal Bankruptcy Act. There are a variety of legitimate reasons — some of them are described in subsections (5)(a) (A.C.A. § 4-9-304(5)(a)) and (5)(b) (A.C.A. § 4-9-304(5)(b)) — why such collateral has to be temporarily released to a debtor and no useful purpose would be served by cluttering the files with records of such exceedingly short term transactions. Under subsection (4) (A.C.A. § 4-9-304(4)) the 21-day perfection runs from the date of attachment; there is no limitation on the purpose for which the debtor is in possession but the secured party must have given new value under a written security agreement. Under subsection (5) (A.C.A. § 4-9-304(5)) the 21-day perfection runs from the date a secured party who already has a perfected security interest turns over the collateral to the debtor (an example is a bank which has acquired a bill of lading by honoring drafts drawn under a letter of credit and subsequently turns over the bill of lading to its customer); there is no new value requirement but the turn-over must be for one or more of the purposes stated in subsections (5)(a) (A.C.A. § 4-9-304(5)(a)) and (5)(b) (A.C.A. § 4-9-304(5)(b)). Note that while subsection (4) (A.C.A. § 4-9-304(4)) is re-



stricted to instruments and negotiable documents, subsection (5) (A.C.A. § 4-9-304(5)) extends to goods covered by non-negotiable documents as well. Thus the letter of credit bank referred to in the example could make a subsection (5) turnover without regard to the form of the bill of lading, provided that, in the case of a non-negotiable document, it had previously perfected its interest under one of the methods stated in subsection (3) (A.C.A. § 4-9-304(3)). But note that the discussion of subsection (5) (A.C.A. § 4-9-304(5)) in this Comment deals only with perfection. Priority of a security interest in inventory after surrender of the document depends on compliance with the requirements of Section 9-312(3) (A.C.A. § 4-9-312(3)) on notice to prior inventory financier.

Finally, it should be noted that the 21 days applies only to the documents and to the goods obtained by surrender thereof. If the goods are sold, the security interest will continue in proceeds for only 10 days under Section 9-306 (A.C.A. § 4-9-306), unless a further perfection occurs as to the security interest in proceeds.

#### *Cross References:*

Article 7 (Chapter 7) and Sections 9-303 (A.C.A. § 4-9-303), 9-305 (A.C.A. § 4-9-305) and 9-312(3) (A.C.A. § 4-9-312(3)).

#### *Definitional Cross References:*

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Document". Section 9-105 (A.C.A. § 4-9-105).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Instrument". Section 9-105 (A.C.A. § 4-9-105).

"Receives notification". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Sections 2-106 (A.C.A. § 4-2-106) and 9-105 (A.C.A. § 4-9-105).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-304), to incorporate the 1972 changes to this Uniform Commercial Code section, and by Acts 1985, No. 514, § 9, to incorporate the 1977 changes to this Uniform Commercial Code section.

### **1972 Official Comment to § 9-305 (A.C.A. § 4-9-305)\***

*Prior Uniform Statutory Provision:* None.

#### *Purposes:*

1. As under the common law of pledge, no filing is required by this Article (Chapter) to perfect a security interest where the secured party has possession of the collateral. Compare Section 9-302(1)(a) (A.C.A. § 4-9-302(1)(a)). This section permits a security interest to be perfected by transfer of possession only when the collateral is goods, instruments (other than certificated securities, which are governed by Section 8-321 (A.C.A. § 4-8-321)), documents or chattel paper: that is to say, accounts and general intangibles are excluded. See Section 5-116 (A.C.A. § 4-5-116) for the special case of assignments of letters and advices of credit. A security interest in accounts and general intangibles — property not ordinarily represented by any writing whose delivery op-

erates to transfer the claim — may under this Article (Chapter) be perfected only by filing, and this rule would not be affected by the fact that a security agreement or other writing described the assignment of such collateral as a "pledge". Section 9-302(1)(e) (A.C.A. § 4-9-302(1)(e)) exempts from filing certain assignments of accounts which are out of the ordinary course of financing: such exempted assignments are perfected when they attach under Section 9-303(1) (A.C.A. § 4-9-303(1)); they do not fall within this section.

2. Possession may be by the secured party himself or by an agent on his behalf: it is of course clear, however, that the debtor or a person controlled by him cannot qualify as such an agent for the secured party. See also the last sentence of Section 9-205 (A.C.A. § 4-9-205). Where the collateral (except for goods covered by

a negotiable document) is held by a bailee, the time of perfection of the security interest, under the second sentence of the section, is when the bailee receives notification of the secured party's interest: this rule rejects the common law doctrine that it is necessary for the bailee to attorn to the secured party or acknowledge that he now holds on his behalf.

3. The third sentence of the section rejects the "equitable pledge" theory of relation back, under which the taking possession was deemed to relate back to the date of the original security agreement. The relation back theory has had little vitality since the 1938 revision of the Federal Bankruptcy Act, which introduced in Section 60a provisions designed to make such interests voidable as preferences in bankruptcy proceedings. This section now brings state law into conformity with the overriding federal policy: where a pledge transaction is contemplated, perfection dates only from the time possession is taken, although a security interest may attach, unperfected, before that under the rules stated in Section 9-204 (A.C.A. § 4-9-204). The only exception to this rule is the short twenty-one day period of perfection provided in Section 9-304(4) (A.C.A. § 4-9-304(4)) and (5) (A.C.A. § 4-9-304(5)) during which a debtor may have possession of specified

collateral in which there is a perfected security interest.

*Cross References:*

Sections 5-116 (A.C.A. § 4-5-116), 9-204 (A.C.A. § 4-9-204), 9-302 (A.C.A. § 4-9-302), 9-303 (A.C.A. § 4-9-303) and 9-304 (A.C.A. § 4-9-304).

*Definitional Cross References:*

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Documents". Section 9-105 (A.C.A. § 4-9-105).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Instruments". Section 9-105 (A.C.A. § 4-9-105).

"Receives notification". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-305), to incorporate the 1972 changes to this Uniform Commercial Code section, and by Acts 1985, No. 514, § 10, to incorporate the 1977 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-306 (A.C.A. § 4-9-306)\***

*Prior Uniform Statutory Provision:* Section 10, Uniform Trust Receipts Act.

*Purposes:*

1. This section (A.C.A. § 4-9-306) states a secured party's right to the proceeds received by a debtor on disposition of collateral and states when his interest in such proceeds is perfected.

It (A.C.A. § 4-9-306) makes clear that insurance proceeds from casualty loss of collateral are proceeds within the meaning of this section.

As to proceeds of consigned goods, see Section 9-114 (A.C.A. § 4-9-114) and the Comment thereto.

2. (a) Whether a debtor's sale of collateral was authorized or unauthorized, prior law generally gave the secured party a claim to the proceeds. Sometimes it was said that the security interest attached to the "property" received in substitution;

sometimes it was said the debtor held the proceeds as "trustee" or "agent" for the secured party. Whatever the formulation of the rule, the secured party, if he could identify the proceeds, could reclaim them or their equivalent from the debtor or his trustee in bankruptcy. This section provides new rules for insolvency proceedings. Paragraphs (4)(a) through (c) (A.C.A. § 4-9-306(4)(a) through 4-9-306(4)(c)) substitute specific rules of identification for general principles of tracing. Paragraph (4)(d) (A.C.A. § 4-9-306(4)(d)) limits the security interest in proceeds not within these rules to an amount of the debtor's cash and deposit accounts not greater than cash proceeds received within ten days of insolvency proceedings less the cash proceeds during this period already paid over and less the amounts for which the security interest is recognized under paragraphs (4)(a) through (c)



(A.C.A. § 4-9-306(4)(a) through 4-9-306(4)(c)).

(b) Subsections (2) (A.C.A. § 4-9-306(2)) and (3) (A.C.A. § 4-9-306(3)) make clear that the four-month period for calculating a voidable preference in bankruptcy begins with the date of the secured party's obtaining the security interest in the original collateral and not with the date of his obtaining control of the proceeds. The interest in the proceeds "continues" as a perfected interest if the original interest was perfected; but the interest ceases to be perfected after the expiration of ten days unless a filed financing statement covered the original collateral and the proceeds are collateral of a type as to which a security interest could be perfected by a filing in the same office or unless the secured party perfects his interest in the proceeds themselves — i.e., by filing a financing statement covering them or by taking possession. See Section 9-312(6) (A.C.A. § 4-9-312(6)) and Comment thereto for priority of rights in proceeds perfected by a filing as to original collateral.

(c) Where cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in ordinary course. The law of fraudulent conveyances would no doubt in appropriate cases support recovery of proceeds by a secured party from a transferee out of ordinary course or otherwise in collusion with the debtor to defraud the secured party.

3. In most cases when a debtor makes an unauthorized disposition of collateral, the security interest, under prior law and under this Article (Chapter) (A.C.A. § 4-9-101 et seq.), continues in the original collateral in the hands of the purchaser or other transferee. That is to say, since the transferee takes subject to the security interest, the secured party may repossess the collateral from him or in an appropriate case maintain an action for conversion. Subsection (2) (A.C.A. § 4-9-306(2)) codifies this rule. The secured party may claim both proceeds and collateral, but may of course have only one satisfaction.

In many cases a purchaser or other transferee of collateral will take free of a

security interest: in such cases the secured party's only right will be to proceeds. A transferee will acquire the collateral free and clear of a preexisting security interest only if the disposition of the collateral by the debtor was authorized by the secured party free and clear of the secured party's security interest. If the disposition was not authorized by the secured party, or was authorized by the secured party subject to the secured party's security interest, the transferee will not acquire the collateral free and clear of the security interest. The authorization may be contained in the security agreement or otherwise given. The right to proceeds, either under the rules of this section (A.C.A. § 4-9-306) or under specific mention thereof in a security agreement or financing statement does not in itself constitute an authorization of sale. PEB Commentary No. 3, dated March 10, 1990, analyzes the interplay between this Section (A.C.A. § 4-9-306) and Section 9-402(7) (A.C.A. § 4-9-402(7)).

Section 9-301 (A.C.A. § 4-9-301) states when transferees take free of unperfected security interests. Sections 9-307 (A.C.A. § 4-9-307) on goods, 9-308 (A.C.A. § 4-9-308) on chattel paper and instruments and 9-309 (A.C.A. § 4-9-309) on negotiable instruments, negotiable documents and securities state when purchasers of such collateral take free of a security interest even though perfected and even though the disposition was not authorized.

4. Subsection (5) (A.C.A. § 4-9-306(5)) states rules to determine priorities when collateral which has been sold is returned to the debtor: for example goods returned to a department store by a dissatisfied customer. The most typical problems involve sale and return of inventory, but the subsection (A.C.A. § 4-9-306(5)) can also apply to equipment. Under the rule of *Benedict v. Ratner*, failure to segregate such returned goods sometimes led to invalidation of the entire security arrangement. This Article (Chapter) rejects the *Benedict v. Ratner* line of cases (see Section 9-205 (A.C.A. § 4-9-205) and Comment). Subsection (5)(a) of this section (A.C.A. § 4-9-306(5)(a)) reinforces the rule of Section 9-205 (A.C.A. § 4-9-205): as between secured party and debtor (and debtor's trustee in bankruptcy) the original security interest continues on the re-

turned goods. Whether or not the security interest in the returned goods is perfected depends upon factors stated in the text.

Paragraphs (5)(b) (A.C.A. § 4-9-306(5)(b)), (c) (A.C.A. § 4-9-306(5)(c)) and (d) (A.C.A. § 4-9-306(5)(d)) deal with a different aspect of the returned goods situation. Assume that a dealer has sold an automobile and transferred the chattel paper or the account arising on the sale to Bank X (which had not previously financed the car as inventory). Thereafter the buyer of the automobile rightfully rescinds the sale, say for breach of warranty, and the car is returned to the dealer. Paragraph (5)(b) (A.C.A. § 4-9-306(5)(b)) gives the bank as transferee of the chattel paper or the account a security interest in the car against the dealer. For protection against dealer's creditors or purchasers from him (other than buyers in the ordinary course of business, see Section 9-307 (A.C.A. § 4-9-307)), Bank X as the transferee, under paragraph (5)(d) (A.C.A. § 4-9-306(5)(d)), must perfect its interest by taking possession of the car or by filing as to it. Perfection of his original interest in the chattel paper or the account does not automatically carry over to the returned car, as it does under paragraph (5)(a) (A.C.A. § 4-9-306(5)(a)) where the secured party originally financed the dealer's inventory.

In the situation covered by (5)(b) (A.C.A. § 4-9-306(5)(b)) and (5)(c) (A.C.A. § 4-9-306(5)(c)) a secured party who financed the inventory and a secured party to whom the chattel paper or the account was transferred may both claim the returned goods — the inventory financier under paragraph (5)(a) (A.C.A. § 4-9-306(5)(a)), the transferee under paragraphs (5)(b) (A.C.A. § 4-9-306(5)(b)) and (5)(c) (A.C.A. § 4-9-306(5)(c)). With respect to chattel paper, Section 9-308 (A.C.A. § 4-9-308) regulates the priorities. With respect to an account, paragraph (5)(c) (A.C.A. § 4-9-306(5)(c)) subordinates the security interest of the transferee of the account to that of the inventory financier. However, if the inventory security interest was unperfected, the transferee's interest could become entitled to priority under the rules stated in Section 9-312(5) (A.C.A. § 4-9-312(5)).

In cases of repossession by the dealer and also in cases where the chattel was returned to the dealer by the voluntary

act of the account debtor, the dealer's position may be that of a mere custodian; he may be an agent for resale, but without any other obligation to the holder of the chattel paper; he may be obligated to repurchase the chattel, the chattel paper or the account from the secured party or to hold it as collateral for a loan secured by a transfer of the chattel paper or the account. If the dealer thereafter sells the chattel to a buyer in ordinary course of business in any of the foregoing cases, the buyer is fully protected under Section 2-403(2) (A.C.A. § 4-2-403(2)) as well as under Section 9-307(1) (A.C.A. § 4-9-307(1)), whichever is technically applicable.

5. "Creditors" and "purchasers" as used in paragraph (5)(d) (A.C.A. § 4-9-306(5)(d)) do not include the original secured inventory financier of the seller of goods under subsection (a) (A.C.A. § 4-9-306(5)(a)). If a purchaser of chattel paper generated by a sale of the goods attains priority over the seller's inventory financier under Section 9-308 (A.C.A. § 4-9-308), the purchaser retains that priority in the event the goods covered by the chattel paper are returned to the seller, without having to further perfect against the inventory financier. This priority issue will usually arise in the context of the original inventory financier and the chattel paper purchaser both claiming the goods or the proceeds of any sale or disposition thereof by the seller. See PEB Commentary No. 5, dated March 10, 1990.

#### *Cross References:*

Sections 9-307 (A.C.A. § 4-9-307), 9-308 (A.C.A. § 4-9-308) and 9-309 (A.C.A. § 4-9-309).

Point 3: Sections 1-205 (A.C.A. § 4-1-205) and 9-301 (A.C.A. § 4-9-301).

Point 4: Sections 2-403(2) (A.C.A. § 4-2-403(2)), 9-205 (A.C.A. § 4-9-205) and 9-312 (A.C.A. § 4-9-312).

#### *Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Bank". Section 1-201 (A.C.A. § 4-1-201).

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Check". Sections 3-104 (A.C.A. § 4-3-104) and 9-105 (A.C.A. § 4-9-105).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).



"Creditors". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Insolvency proceedings". Section 1-201 (A.C.A. § 4-1-201).

"Money". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Sections 2-106 (A.C.A. § 4-2-106) and 9-105 (A.C.A. § 4-9-105).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by: Acts 1973, No. 116, § 1 (9-306), to incorporate the 1972 changes to this Uniform Commercial Code section; and Acts 1975, No. 215, § 1, and Acts 1983, No. 561, § 4, to vary the language from that of the Uniform Commercial Code section. References in numbered paragraph (2) of the commentary to this section regarding the ten-day period should be noted since Arkansas has adopted a twenty-one-day period.

### 1972 Official Comment to § 9-307 (A.C.A. § 4-9-307)\*

*Prior Uniform Statutory Provision:* Section 9, Uniform Conditional Sales Act; Section 9(2), Uniform Trust Receipts Act.

#### *Purposes:*

This section (A.C.A. § 4-9-307) was amended by Acts 1989, No. 655, § 1, which repealed subsections (4)-(6). Due to this repeal, former subsection (7) is deemed obsolete. The effect of the 1989 repeal was to bring the section back into conformity with the Uniform Commercial Code (A.C.A. § 4-1-101 et seq.) provision.

#### *Cross References:*

Point 1: Sections 2-403 (A.C.A. § 4-2-403) and 9-301 (A.C.A. § 4-9-301).

Point 2: Section 9-306 (A.C.A. § 4-9-306).

Point 3: Sections 9-301 (A.C.A. § 4-9-301) and 9-302 (A.C.A. § 4-9-302).

Point 4: Sections 9-301(4) (A.C.A. § 4-9-301(4)) and 9-312(7) (A.C.A. § 4-9-312(7)).

#### *Definitional Cross References:*

"Buyer in ordinary course of business". Section 1-201 (A.C.A. § 4-1-201).

"Consumer goods". Section 9-109 (A.C.A. § 4-9-109).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Knows" and "Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Pursuant to commitment". Section 9-105 (A.C.A. § 4-9-105).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-307), to incorporate the 1972 changes to this Uniform Commercial Code section, and by Acts 1986 (2nd Ex. Sess.), No. 16, § 1, to add additional subsections (4), (5), and (6). Acts 1987, No. 108, § 6, added subsection (7) to the Arkansas Code section. These additions created variations from this Uniform Commercial Code section, which does not contain these subsections.

**1972 Official Comment to § 9-308 (A.C.A. § 4-9-308)\***

*Prior Uniform Statutory Provision:* Sections 9(a) and 10 of the Uniform Trust Receipts Act.

*Purposes:*

1. Chattel paper is defined (Section 9-105 (A.C.A. § 4-9-105)) as "a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods". Such paper has become an important class of collateral in financing arrangements, which may — as in the automobile and some other fields — follow an earlier financing arrangement covering inventory or which may begin with the chattel paper itself.

Arrangements where the chattel paper is delivered to the secured party who then makes collections, as well as arrangements where the debtor, whether or not he is left in possession of the paper, makes the collections, are both widely used, and are known respectively as notification (or "direct collection") and non-notification (or "indirect collection") arrangements. In the automobile field, for example, when a car is sold to a consumer buyer under an installment purchase agreement and the resulting chattel paper is assigned, the assignee usually takes possession, the obligor is notified of the assignment and is directed to make payments to the assignee. In the furniture field, for an example on the other hand, the chattel paper may be left in the dealer's hands or delivered to the assignee; in either case the obligor may not be notified, and payments are made to the dealer-assignor who receives them under a duty to remit to his assignee. The widespread use of both methods of dealing with chattel paper is recognized by the provisions of this Article (Chapter) (A.C.A. § 4-9-101 et seq.), which permit perfection of a chattel paper security interest either by filing or by taking possession.

2. Although perfection by filing is permitted as to chattel paper, certain purchasers of chattel paper allowed to remain in the debtor's possession take free of the security interest despite the filing.

Clause (b) (A.C.A. § 4-9-308(b)) of the section deals with the case where the security interest in the chattel paper is claimed merely as proceeds — i.e., on behalf of an inventory financier who has

not by some new transaction with the debtor acquired a specific interest in the chattel paper. In that case a purchaser, even though he knows of the inventory financier's proceeds interest, takes priority provided he gives new value and takes possession of the paper in the ordinary course of his business.

The same basic rule applies in favor of a purchaser of other instruments who claims priority against a proceeds interest therein of which he has knowledge. Thus a purchaser of a negotiable instrument might prevail under clause (b) (A.C.A. § 4-9-308(b)) even though his knowledge of the conflicting proceeds claim precluded his having holder in due course status under Section 9-309 (A.C.A. § 4-9-309).

3. Clause (a) (A.C.A. § 4-9-308(a)) deals with the case where the nonpossessory security interest in the chattel paper is more than a mere claim to proceeds — i.e., exists in favor of a secured party who has given value against the paper, whether or not he financed the inventory whose sale gave rise to it. In this case the purchaser, to take priority, must not only give new value and take possession in the ordinary course of his business; he must also take without knowledge of the existing security interest. Thus a secured party, who has a specific interest in the chattel paper and not merely a claim to proceeds, and who wishes to leave the paper in the debtor's possession can, because of the knowledge requirement, protect himself against purchasers by stamping or noting on the paper the fact that it has been assigned to him. A chattel paper financier who gives new value and takes possession of chattel paper in the ordinary course of his business and is without knowledge of prior security interests in the chattel paper has no duty to search for Article 9 (A.C.A. § 4-9-101 et seq.) filings against the chattel paper or to make other inquiries which might reveal perfected prior interests in the paper, even though the chattel paper financier is aware of the possibility that a prior security interest exists. Mere knowledge of an Article 9 (A.C.A. § 4-9-101 et seq.) filing against chattel paper does not give knowledge of the existence of a security interest in the chattel paper. See PEB



Commentary No. 8, dated December 10, 1991.

4. It should be noted that under Section 9-304(1) (A.C.A. § 4-9-304(1)) a security interest in an instrument, negotiable or nonnegotiable, cannot be perfected by filing (except where the instrument constitutes part of chattel paper). Thus the only types of perfected nonpossessory security interest that can arise in an instrument are the temporary 21-day perfection provided for in Section 9-304(4) (A.C.A. § 4-9-304(4)) and (5) (A.C.A. § 4-9-304(5)) or the 10 day perfection in proceeds of Section 9-306 (A.C.A. § 4-9-306). Where such a perfected interest exists in a nonnegotiable instrument, purchasers will take free if they qualify under clause (a) (A.C.A. § 4-9-308(a)) of the section.

*Cross References:*

Point 1: Sections 9-304(1) (A.C.A. § 4-9-304(1)) and 9-305 (A.C.A. § 4-9-305).

Point 2: Section 9-306 (A.C.A. § 4-9-306).

Point 4: Sections 9-304 (A.C.A. § 4-9-304) and 9-306 (A.C.A. § 4-9-306).

**1972 Official Comment to § 9-309 (A.C.A. § 4-9-309)\***

*Prior Uniform Statutory Provision:* Section 9(a), Uniform Trust Receipts Act.

*Purposes:*

1. Under this Article (Chapter) (A.C.A. § 4-9-101 et seq.) as at common law and under prior statutes the rights of purchasers of negotiable paper, including negotiable documents of title and investment securities, are determined by the rules of holding in due course and the like which are applicable to the type of paper concerned (Articles 3 (Chapter 3), 7 (Chapter 7), and 8 (Chapter 8) (A.C.A. § 4-3-101 et seq., § 4-7-101 et seq., and § 4-8-101 et seq.)). This section (A.C.A. § 4-9-309), as did Section 9(a) of the Uniform Trust Receipts Act, makes explicit the rule which was implicitly but universally recognized under the earlier statutes.

2. Under Section 9-304(1) (A.C.A. § 4-9-304(1)) filing is ineffective to perfect a security interest in instruments (including securities) except those instruments which are part of chattel paper, and of course is ineffective to constitute notice to subsequent purchasers. Although filing is permissible as a method of perfection for a

*Definitional Cross References:*

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Instrument". Section 9-105 (A.C.A. § 4-9-105).

"Inventory". Section 9-109 (A.C.A. § 4-9-109).

"Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Proceeds". Section 9-306 (A.C.A. § 4-9-306).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-308), to incorporate the 1972 changes to this Uniform Commercial Code section.

security interest in documents, this section (A.C.A. § 4-9-309) follows the policy of the Uniform Trust Receipts Act in providing that the filing does not constitute notice to purchasers.

3. The operation of this section (A.C.A. § 4-9-309) can be seen when two secured parties have a perfected security interest in an account, chattel paper, or general intangible and the secured party that does not have priority receives a payment by check directly or indirectly from the account debtor. If the recipient takes the check under circumstances that give the recipient the rights of a holder in due course (Section 3-302) (A.C.A. § 4-3-302), then the recipient's security interest in the check will take priority over the competing security interest and the recipient will be entitled to keep the payment. See Commentary No. 7, dated March 10, 1990.

*Cross References:*

Articles 3 (Chapter 3), 7 (Chapter 7), and 8 (Chapter 8) (A.C.A. § 4-3-101 et seq., § 4-7-101 et seq., and § 4-8-101 et seq.) and Sections 9-304(1) (A.C.A. § 4-9-304(1)) and 9-308 (A.C.A. § 4-9-308).

*Definitional Cross References:*

"Bona fide purchaser". Section 8-302 (A.C.A. § 4-8-302).

"Document of title". Section 1-201 (A.C.A. § 4-1-201).

"Duly negotiated". Section 7-501 (A.C.A. § 4-7-501).

"Holder". Section 1-201 (A.C.A. § 4-1-201).

"Holder in due course". Sections 3-302 (A.C.A. § 4-3-302) and 9-105 (A.C.A. § 4-9-105).

"Negotiable instrument". Sections 3-104 (A.C.A. § 4-3-104) and 9-105 (A.C.A. § 4-9-105).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

### 1972 Official Comment to § 9-310 (A.C.A. § 4-9-310)

*Prior Uniform Statutory Provision:* Section 11, Uniform Trust Receipts Act.

*Purposes:*

1. To provide that liens securing claims arising from work intended to enhance or preserve the value of the collateral take priority over an earlier security interest even though perfected.

2. Apart from the Uniform Trust Receipts Act which had a section similar to this one, there was generally no specific statutory rule as to priority between security devices and liens for services or materials. Under chattel mortgage or conditional sales law many decisions made the priority of such liens turn on whether the secured party did or did not have "title". This section changes such rules and makes the lien for services or materials prior in all cases where they are furnished in the ordinary course of the lienor's business and the goods involved are in the lienor's possession. Some of the statutes

creating such liens expressly make the lien subordinate to a prior security interest. This section does not repeal such statutory provisions. If the statute creating the lien is silent, even though it has been construed by decision to make the lien subordinate to the security interest, this section provides a rule of interpretation that the lien should take priority over the security interest.

*Cross References:*

Sections 9-102(2) (A.C.A. § 4-9-102(2)), 9-104(c) (A.C.A. § 4-9-104(c)) and 9-312(1) (A.C.A. § 4-9-312(1)).

*Definitional Cross References:*

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

### 1972 Official Comment to § 9-311 (A.C.A. § 4-9-311)

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. To make clear that in all security transactions under this Article (Chapter), the debtor has an interest (whether legal title or an equity) which he can dispose of and which his creditors can reach.

2. Some jurisdictions have held that when a mortgagee or conditional seller has "title" to the collateral, creditors may not proceed against the mortgagor's or vendee's interest by levy, attachment or other judicial process. This section changes those rules by providing that in all security interests the debtor's interest in the collateral remains subject to claims of creditors who take appropriate action.

It is left to the law of each state to determine the form of "appropriate process".

3. Where the security interest is in inventory, difficult problems arise with reference to attachment and levy. Assume that a debt of \$100,000 is secured by inventory worth twice that amount. If by attachment or levy certain units of the inventory are seized, the determination of the debtor's equity in the units seized is not a simple matter. The section leaves the solution of this problem to the courts. Procedures such as marshalling may be appropriate.

*Cross References:*

Sections 9-301(4) (A.C.A. § 4-9-301(4)), 9-307(3) (A.C.A. § 4-9-307(3)), 9-312(7) (A.C.A. § 4-9-312(7)).



*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Section 2-106 (A.C.A. § 4-2-106) and 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

**1972 Official Comment to § 9-312 (A.C.A. § 4-9-312)\***  
**(Also see following comment)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. In a variety of situations two or more people may claim an interest in the same property. The several sections specified in subsection (1) (A.C.A. § 4-9-312(1)) contain rules for determining priorities between security interests and such other claims in the situations covered in those sections. For cases not covered in those sections this section (A.C.A. § 4-9-312) states general rules of priority between conflicting security interests.

2. Subsection (2) (A.C.A. § 4-9-312(2)) gives priority to a new value security interest in crops based on a current crop production loan over an earlier security interest in the crop which secured obligations (such as rent, interest or mortgage principal amortization) due more than six months before the crops become growing crops. This priority is not affected by the fact that the person making the crop loan knew of the earlier security interest.

3. Subsections (3) (A.C.A. § 4-9-312(3)) and (4) (A.C.A. § 4-9-312(4)) give priority to a purchase money security interest (defined in Section 9-107 (A.C.A. § 4-9-107)) under certain conditions over non-purchase money interests, which in this context will usually be interests asserted under after-acquired property clauses. See Section 9-204 (A.C.A. § 4-9-204) on the extent to which after-acquired property interests are validated and Section 9-108 (A.C.A. § 4-9-108) on when a security interest in after-acquired property is deemed taken for new value.

Prior law, under one or another theory, usually contrived to protect purchase money interests over after-acquired property interests (to the extent to which the after-acquired property interest was recognized at all). For example, in the field of industrial equipment financing it was possible, by manipulation of title theory, for

the purchase money financier of new equipment (under conditional sale or equipment trust) to protect himself against the claims of prior mortgagees or bondholders under an after-acquired clause in the mortgage or trust indenture: the result was arrived at on the theory that since "title" to the equipment was never in the vendee or lessee there was nothing for the lien of the mortgage to attach to. While this Article (Chapter) (A.C.A. § 4-9-101 et seq.) broadly validates the after-acquired property interest, it also recognizes as sound the preference which prior law gave to the purchase money interest. That policy is carried out in subsections (3) (A.C.A. § 4-9-312(3)) and (4) (A.C.A. § 4-9-312(4)).

Subsection (4) (A.C.A. § 4-9-312(4)) states a general rule applicable to all types of collateral except inventory: the purchase money interest takes priority if it is perfected when the debtor receives possession of the collateral or within ten days thereafter. As to the ten day grace period, compare Section 9-301(2) (A.C.A. § 4-9-301(2)). The perfection requirement means that the purchase money secured party either has filed a financing statement before that time or has a temporarily perfected interest in goods covered by documents under Section 9-304(4) (A.C.A. § 4-9-304(4)) and (5) (A.C.A. § 4-9-304(5)) (which is continued in a perfected status by filing before the expiration of the 21 day period specified in that section). There is no requirement that the purchase money secured party be without notice or knowledge of the other interest; he takes priority although he knows of it or it has been filed.

Under subsection (3) (A.C.A. § 4-9-312(3)) the same rule of priority, but without the ten day grace period for filing, applies to a purchase money security interest in inventory, with the additional

requirement that the purchase money secured party give notification, as stated in subsection (3) (A.C.A. § 4-9-312(3)), to any other secured party who filed earlier for the same item or type of inventory. The reason for the additional requirement of notification is that typically the arrangement between an inventory secured party and his debtor will require the secured party to make periodic advances against incoming inventory or periodic releases of old inventory as new inventory is received. A fraudulent debtor may apply to the secured party for advances even though he has already given a security interest in the inventory to another secured party. The notification requirement protects the inventory financier in such a situation: if he has received notification, he will presumably not make an advance; if he has not received notification (or if the other interest does not qualify as a purchase money interest), any advance he may make will have priority. Since an arrangement for periodic advances against incoming property is unusual outside the inventory field, no notification requirement is included in subsection (4) (A.C.A. § 4-9-312(4)).

Where the purchase money inventory financing began by possession of a negotiable document of title by the secured party, he must in order to retain priority give the notice required by subsection (3) (A.C.A. § 4-9-312(3)) at or before the usual time, i.e., when the debtor gets possession of the inventory, even though his security interest remains perfected for 21 days under Section 9-304(5) (A.C.A. § 4-9-304(5)).

When under these rules the purchase money secured party has priority over another secured party, the question arises whether this priority extends to the proceeds of the original collateral. Under subsection (4) (A.C.A. § 4-9-312(4)) which deals with non-inventory collateral and where there was no ordinary expectation that the goods would be sold, the section gives an affirmative answer. In the case of inventory collateral under subsection (3) (A.C.A. § 4-9-312(3)), where it was expected that the goods would be sold and where financing frequently is based on the resulting accounts, chattel paper, or other proceeds, the subsection gives an answer limited to the preservation of the purchase money priority only insofar as the

proceeds are cash received on or before the delivery of the inventory to a buyer, that is, without the creation of an intervening account to which conflicting rights might attach. The conflicting rights to proceeds consisting of accounts are governed by subsection (5) (A.C.A. § 4-9-312(5)). See Comment 8.

The foregoing rules applicable to purchase money security interests in inventory apply also to the rights in consigned merchandise. See Section 9-114 (A.C.A. § 4-9-114).

4. Subsection (5) (A.C.A. § 4-9-312(5)) states a rule for determining priority between conflicting security interests in cases not covered in the sections referred to in subsection (1) (A.C.A. § 4-9-312(1)) or in subsections (2) (A.C.A. § 4-9-312(2)), (3) (A.C.A. § 4-9-312(3)) and (4) (A.C.A. § 4-9-312(4)) of this section. Note that subsection (5) (A.C.A. § 4-9-312(5)) applies to cases of purchase money security interests which do not qualify for the special priorities set forth in subsections (3) (A.C.A. § 4-9-312(3)) and (4) (A.C.A. § 4-9-312(4)).

There is a single priority rule based on precedence in the time as of which the competing parties either filed their security interests or perfected their security interests. The form of the claim to priority, i.e., filing or perfection, may shift from time to time, and the rank will be based on the first filing or perfection so long as there is no intervening period without filing or perfection. Filing may occur as to particular collateral before the collateral comes into existence. Under the standards of Section 9-203 (A.C.A. § 4-9-203) perfection cannot occur as to particular collateral until the collateral itself (and not prior collateral) comes into existence and the debtor has rights therein; but under subsection (6) (A.C.A. § 4-9-312(6)) of this section the secured party's priority may date from his time of perfection as to the prior collateral, if perfection or filing has been continuously maintained. Subsection (6) (A.C.A. § 4-9-312(6)) provides that a date of filing or perfection as to original collateral is also a date of filing or perfection as to proceeds. This rule should also be read with Section 9-306 (A.C.A. § 4-9-306), which makes it unnecessary to claim proceeds expressly in a financing statement and provides in effect that a filing as to original collateral is also a



filing as to proceeds (with exceptions therein stated). Thus, if a financing statement is filed covering inventory, then (subject to the exception involving multistate problems) this filing is also a filing as to the resulting accounts and constitutes the date of filing as to the accounts.

The party who may have had a prior security interest in inventory or may have had the only such security interest does not automatically for that reason have priority as to the accounts. His claim to accounts may or may not have priority over competing filed claims to accounts. The priority is based on precedence as to the accounts under the rules stated in the preceding paragraph.

5. The operation of this section is illustrated by the examples set forth under this and the succeeding Points.

Example 1. A files against X (debtor) on February 1. B files against X on March 1. B makes a non-purchase money advance against certain collateral on April 1. A makes an advance against the same collateral on May 1. A has priority even though B's advance was made earlier and was perfected when made. It makes no difference whether or not A knew of B's interest when he made his advance.

The problem stated in the example is peculiar to a notice filing system under which filing may be made before the security interest attaches (see Section 9-402 (A.C.A. § 4-9-402)). The Uniform Trust Receipts Act, which first introduced such a filing system, contained no hint of a solution and case law under it was unpredictable. This Article (Chapter) follows several of the accounts receivable statutes in determining priority by order of filing. The justification for the rule lies in the necessity of protecting the filing system — that is, of allowing the secured party who has first filed to make subsequent advances without each time having, as a condition of protection, to check for filings later than his. Note, however, that his protection is not absolute: if, in the example, B's advance creates a purchase money security interest, he has priority under subsection (4) (A.C.A. § 4-9-312(4)), or, in the case of inventory, under subsection (3) (A.C.A. § 4-9-312(3)) provided he has properly notified A. (See further Example 3 below.)

Example 2. A and B make nonpurchase

money advances against the same collateral. The collateral is in the debtor's possession and neither interest is perfected when the second advance is made. Whichever secured party first perfects his interest (by taking possession of the collateral or by filing) takes priority and it makes no difference whether or not he knows of the other interest at the time he perfects his own.

This result may be regarded as an adoption, in this type of situation, of the idea, deeply rooted at common law, of a race of diligence among creditors. Subsection (5)(b) (A.C.A. § 4-9-312(5)(b)) adds the thought that so long as neither of the interests is perfected, the one which first attached (i.e., under the advance first made) has priority. The last mentioned rule may be thought to be of merely theoretical interest, since it is hard to imagine a situation where the case would come into litigation without either A or B having perfected his interest. If neither interest had been perfected at the time of the filing of a petition in bankruptcy, of course neither would be good against the trustee in bankruptcy.

Example 3. A has a temporarily perfected (21 day) security interest, unfiled, in a negotiable document in the debtor's possession under Section 9-304(4) (A.C.A. § 4-9-304(4)) or (5) (A.C.A. § 4-9-304(5)). On the fifth day B files and thus perfects a security interest in the same document. On the tenth day A files. A has priority, whether or not he knows of B's interest when he files, because he perfected first and has maintained continuous perfection or filing.

6. The application of the priority rules to after-acquired property must be considered separately for each item of collateral. Priority does not depend only on time of perfection, but may also be based on priority in filing before perfection.

Example 4. On February 1, A makes advances to X under a security agreement which covers "all the machinery in X's plant" and contains an after-acquired property clause. A promptly files his financing statement. On March 1, X acquires a new machine, B makes an advance against it and files his financing statement. On April 1, A, under the original security agreement, makes an advance against the machine acquired March 1. If B's advance creates a purchase

money security interest, he has priority under subsection (4) (A.C.A. § 4-9-312(4)) (provided he filed before X received possession of the machine or within ten days thereafter). If B's advance, although he gave new value, did not create a purchase money interest, A has priority as to both of his advances by virtue of his priority in filing, although the parties perfected simultaneously on March 1 as to the new machine.

The application of the priority rules to proceeds presents special features discussed in Comment 8.

7. The application of the priority rules to future advances is complicated. In general, since any secured party must operate in reference to the Code's system of notice, he takes subject to future advances under a prior security interest while it is perfected through filing or possession, whether the advances are committed or noncommitted, and to any advances subsequently made "pursuant to commitment" (Section 9-105 (A.C.A. § 4-9-105)) during that period. In the rare case when a future advance is made without commitment while the security interest is perfected temporarily without either filing or possession, the future advance has priority from the date it is made. These rules are more liberal toward the priority of future advances than the corresponding rules applicable to an intervening buyer (Section 9-307(3) (A.C.A. § 4-9-307(3))) because of the different characteristics of the intervening party. Compare the corresponding rule applicable to an intervening judgment creditor. (Section 9-301(4) (A.C.A. § 4-9-301(4))).

Example 5. On February 1, A makes an advance against machinery in the debtor's possession and files his financing statement. On March 1, B makes an advance against the same machinery and files his financing statement. On April 1, A makes a further advance, under the original security agreement, against the same machinery (which is covered by the original financing statement and thus perfected when made). A has priority over B both as to the February 1 and as to the April 1 advance and it makes no difference whether or not A knows of B's intervening advance when he makes his second advance.

A wins, as to the April 1 advance, because he first filed even though B's inter-

est attached, and indeed was perfected, before the April 1 advance. The same rule would apply if either A or B had perfected through possession. Section 9-204(3) (A.C.A. § 4-9-204(3)) and the Comment thereto should be consulted for the validation of future advances.

The same result would be reached even though A's April 1 advance was not under the original security agreement, but was under a new security agreement under A's same financing statement or during the continuation of A's possession.

8. The application of the priority rules of subsections (5) (A.C.A. § 4-9-312(5)) and (6) (A.C.A. § 4-9-312(6)) to proceeds is shown by the following examples:

Example 6. A files a financing statement covering a described type of inventory then owned or thereafter acquired. B subsequently takes a purchase money security interest in certain inventory described in A's financing statement and achieves priority over A under subsection (3) (A.C.A. § 4-9-312(3)) as to this inventory. This inventory is then sold, producing proceeds.

If the proceeds of the inventory are instruments or chattel paper, the rights of A and B on the one hand and any adverse claimant to these proceeds on the other are governed by Sections 9-308 (A.C.A. § 4-9-308) and 9-309 (A.C.A. § 4-9-309). If the proceeds are cash, subsection (3) (A.C.A. § 4-9-312(3)) indicates that B's priority as to the inventory carries over to the cash. Proceeds which are accounts constitute different collateral and the priorities as to the original collateral do not control the priority as to the accounts. Under Sections 9-306 (A.C.A. § 4-9-306) and 9-312(6) (A.C.A. § 4-9-312(6)), A's first filing as to the inventory constitutes a first filing as to the accounts, provided that the same filing office would be appropriate for filing as to accounts under the rules of Section 9-306(3) (A.C.A. § 4-9-306(3)). Therefore, A has priority as to the accounts.

Many parties financing inventory are quite content to protect their first security interest in the inventory itself, realizing that when inventory is sold, someone else will be financing the accounts and the priority for inventory will not run forward to the accounts. Indeed, the cash supplied by the accounts financier will be used to pay the inventory financing. In some sit-



uations, the party financing the inventory on a purchase money basis makes contractual arrangements that the proceeds of accounts financing by another be devoted to paying off the first inventory security interest.

Example 7. In the foregoing case, if B had filed directly as to accounts, the date of that filing as to accounts would be compared with the date of A's first filing as to the inventory, and the first-to-file rule would prevail.

Subsection (6) (A.C.A. § 4-9-312(6)) provides that a filing as to original collateral determines the date of a filing as to the proceeds thereof. This rule implies, of course, that the filing as to the original collateral is effective as to proceeds under the rule of Section 9-306(3) (A.C.A. § 4-9-306(3)).

Example 8. If C had filed as to accounts in Example 6 above before either A or B had filed as to inventory, C's first filing as to accounts would have priority over the filings of A and B, which would also constitute filings as to accounts under the rule just mentioned. A's and B's position as to the inventory gives them no automatic claim to the proceeds of the inventory consisting of accounts against someone who has filed earlier as to accounts. If, on the other hand, either A's or B's filings as to the inventory constituted good filings as to accounts and these filings preceded C's direct filings as to accounts, A or B would outrank C as to the accounts.

If the filings as to inventory were not effective under subsection (6) (A.C.A. § 4-9-312(6)) for filing as to accounts because a filing for accounts would have to be in a different filing office under Section 9-103(3) (A.C.A. § 4-9-103(3)), these inventory filings would nevertheless be effective for 10 days as to accounts. If the perfection of the security interest in accounts was continued within the 10 days by appropriate filings, then A and B's interests in the accounts would date from the date of filing as to inventory.

9. Under some circumstances, a secured party, who does not have priority in an account, chattel paper, or general intangible may be entitled to keep a cash payment received directly or indirectly from the account debtor. See PEB Commentary No. 7, dated March 10, 1990.

#### *Cross References:*

Sections 9-204(1) (A.C.A. § 4-9-204(1))

and 9-303 (A.C.A. § 4-9-303).

Point 1: Sections 4-208 (A.C.A. § 4-4-208), 9-114 (A.C.A. § 4-9-114), 9-301 (A.C.A. § 4-9-301), 9-304 (A.C.A. § 4-9-304), 9-306 (A.C.A. § 4-9-306), 9-307 (A.C.A. § 4-9-307), 9-308 (A.C.A. § 4-9-308), 9-309 (A.C.A. § 4-9-309), 9-310 (A.C.A. § 4-9-310), 9-313 (A.C.A. § 4-9-313), 9-314 (A.C.A. § 4-9-314), 9-315 (A.C.A. § 4-9-315) and 9-316 (A.C.A. § 4-9-316).

Point 3: Sections 9-108 (A.C.A. § 4-9-108), 9-204 (A.C.A. § 4-9-204), 9-304(4) (A.C.A. § 4-9-304(4)) and (5) (A.C.A. § 4-9-304(5)).

Points 4 to 7: Sections 9-204 (A.C.A. § 4-9-204), 9-301(4) (A.C.A. § 4-9-301(4)), 9-304(4) (A.C.A. § 4-9-304(4)) and (5) (A.C.A. § 4-9-304(5)), 9-306 (A.C.A. § 4-9-306), 9-307(3) (A.C.A. § 4-9-307(3)) and 9-402(1) (A.C.A. § 4-9-402(1)).

Point 8: Sections 9-103(6) (A.C.A. § 4-9-103(6)), 9-306(3) (A.C.A. § 4-9-306(3)).

#### *Definitional Cross References:*

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Collecting bank". Section 4-105 (A.C.A. § 4-4-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Documents". Section 9-105 (A.C.A. § 4-9-105).

"Give notice". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Instruments". Section 9-105 (A.C.A. § 4-9-105).

"Inventory". Section 9-109 (A.C.A. § 4-9-109).

"Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Proceeds". Section 9-306 (A.C.A. § 4-9-306).

"Purchase money security interest". Section 9-107 (A.C.A. § 4-9-107).

"Pursuant to commitment". Section 9-105 (A.C.A. § 4-9-105).

"Receives notification". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security". Sections 8-102 (A.C.A. § 4-8-102) and 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by: Acts 1973, No. 116, § 1 (9-312), to incorporate the 1972 changes to this Uniform Commercial Code section; Acts 1983, No. 561, § 5, to

substitute "twenty-one (21) days" for "ten days" in subsection (4); and Acts 1985, No. 514, § 12, to incorporate the 1977 changes to this Uniform Commercial Code section. Acts 1987, No. 560, § 1, amended this section to change the language making it vary from this Uniform Commercial Code section. The Arkansas General Assembly, by Acts 1989, No. 654, §§ 1, 3, repealed (2)(e) and amended (2)(f). The section still varies substantially from the Uniform Commercial Code section.

**Comment to A.C.A. § 4-9-312 adopted by the  
Arkansas General Assembly\*  
(Also see preceding comment)**

Arkansas Statute 85-9-312(2) (A.C.A. § 4-9-312(2)) is an instance of the preference which the Uniform Commercial Code gives a new-value secured party. The principle of this provision (A.C.A. § 4-9-312) is that a person who extends credit that enables a debtor to produce new crops or raise livestock, and secures this credit with a security interest in the farm products, gets first claim to the collateral, outranking the interest of another secured party who claims the collateral merely as after-acquired property to secure a debt not directly related to the production of the farm products. So Arkansas Statute 85-9-312(2) (A.C.A. § 4-9-312(2)) creates an exception to the first-to-file-or-perfect rule of Arkansas Statute 85-9-312(5) (A.C.A. § 4-9-312(5)), as do subsections (3) (A.C.A. § 4-9-312(3)) and (4) (A.C.A. § 4-9-312(4)) of that Statute (Section). The purposes behind all these exceptions are the same: to enable free-market forces to operate with respect to a debtor's acquisition of new property and to prevent unjust enrichment. Arkansas Statute 85-9-312(2) (A.C.A. § 4-9-312(2)) has the effect of putting farming on a par with any other business with respect to secured financing.

The notification requirement is to protect an earlier secured party who may periodically extend credit with respect to the same farm products, such as a bank lending farm operating expenses to the debtor. See Arkansas Statute 85-9-312(3)(b) (A.C.A. § 4-9-312(3)(b)). The filing requirement serves subsequent creditors by providing a means whereby they can learn of existing or expected interests in the collateral.

The holder of a production money security interest may extend value more than once with respect to the same farm products. The holder need not give the notice or make a filing each time value is extended. Rather, a single notice and filing, properly accomplished, protects the holder as to all value the holder contemporaneously and subsequently extends with respect to farm products covered by the notice and filing.

Priority under Arkansas Statute 85-9-312(2) (A.C.A. § 4-9-312(2)) is not conditioned on the production money secured party being without notice or knowledge of the conflicting security interest: the production money secured party takes priority although he actually or constructively knows of it. In this respect, Arkansas Statute 85-9-312(2) (A.C.A. § 4-9-312(2)) is no different from Arkansas Statute 85-9-312(3) (A.C.A. § 4-9-312(3)) and (4) (A.C.A. § 4-9-312(4)).

The usual rule for determining priority between conflicting new-value interests in any kind of collateral is first-to-perfect. Accordingly, priority among production money security interests in the same farm products is usually governed by Arkansas Statute 85-9-312(5) (A.C.A. § 4-9-312(5)), which also governs when a purchase money security interest in livestock conflicts with a production money security interest in the animals. There is a limited exception, however, in the very last clause of Arkansas Statute 85-9-312(2)(a) (A.C.A. § 4-9-312(2)(a)), which is designed to encourage a creditor with whom the debtor may have enjoyed a long relationship to continue to finance the debtor's produc-



tion of crops. This exception broadens the priority of a production money secured party who substantially finances this year's crop so that his priority extends not only to the value he contributed to the current crop that is the collateral, but extends also to any other farm related debts secured by the collateral, including debts for producing crops grown in previous years.

The value that will support a production money security interest includes a loan of money by a lender or other financier or by extension of credit by a seller or other supplier of goods or services. See Arkansas Statute 85-1-201(44) (A.C.A. § 4-1-201(44)). A production money security interest is created for new value given in the good faith belief that the value will be used to enable the debtor to produce or raise the collateral even though the value is not in fact so used by the debtor. Conditioning the priority of a production money security interest on proof that the value was actually used in producing or raising the collateral would impose on farm lenders and suppliers unreasonable burdens of accounting and tracing.

Producing or raising farm products entails a wide range of many activities, each of which is useful or necessary to the process. Security interests based on value extended for all of these activities must qualify for the priority of this subsection so that the debtor can freely shop for enabling credit at every step of production. Thus, Arkansas Statute 85-9-312(2) (A.C.A. § 4-9-312(2)) deliberately defines "producing or raising farm products" broadly: any causally related activity, including activities associated with marketing the collateral.

Producing crops thus includes preparing the land for planting, cultivating or otherwise tending crops, harvesting, preparing crops for sale or storage prior to sale, storing crops prior to sale, transporting to sale, selling, or engaging in any other activity that proximately relates to the growing and marketing of crops or products of crops. Similarly, raising livestock includes feeding or grazing, fencing, providing health care, breeding, slaughtering, preparing for sale, transporting to sale, selling, or engaging in any other activity that proximately relates to the

care and marketing of livestock or products of livestock.

Advances to cover current operating expenses, and to sustain the farmer and his family, are as important to producing farm products as credit extended to buy seed for the new crop or feed for the livestock. Operating expenses are the costs of doing business, i.e., the usual and necessary costs of maintaining the farming operation that produces the collateral, excluding obligations owed with respect to the farmland such as rent, mortgage principal or interest. The land itself always serves as collateral for a mortgagee or vendor of the real estate. Statutory liens on the crops commonly protect cash rent due landlords.

The financier of farm machinery or other farm equipment in a sense enables the production of crops or raising of livestock. Yet, this person has the security of a first claim to the equipment itself and as to farm products should rank below suppliers of goods, services, and money that is consumed in the production process.

The priority granted by Arkansas Statute 85-9-312(2) (A.C.A. § 4-9-312(2)) extends to proceeds of farm products, see Arkansas Statute 85-9-306 (A.C.A. § 4-9-306), and also to products of the collateral including milk and eggs. Products are expressly, separately covered in the subsection, without limitation, to make clear that the production money interest itself (Arkansas Statute 85-9-312(2)(c) (A.C.A. § 4-9-312(2)(c))), and the priority of the interest (Arkansas Statute 85-9-312(2)(a) (A.C.A. § 4-9-312(2)(a))), continue in products of the collateral free from the requirements that must be satisfied under Arkansas Statute 85-9-109(3) (A.C.A. § 4-9-109(3)) for products of crops and livestock to be classified as farm products. Thus, under Arkansas Statute 85-9-312(2)(c) (A.C.A. § 4-9-312(2)(c)) a production money security interest in crops, livestock or other farm products extends automatically to products of the collateral, even though the debtor is no longer in possession of them (compare Arkansas Statute 85-9-306(2) (A.C.A. § 4-9-306(2))); and, under Arkansas Statute 85-9-312(2)(a) (A.C.A. § 4-9-312(2)(a)), this continuing interest in products enjoys the same absolute priority as the production money security interest in the original collateral that is the source of the prod-

ucts so long as the products are identifiable as such. If products are confused with other goods and can no longer be identified, that is, their identity is lost in the mass, the security interest is not lost. Rather, the interest continues, and priority is determined, pursuant to Arkansas Statute 85-9-315 (A.C.A. § 4-9-315). Because Arkansas Statute 85-9-315(1) (A.C.A. § 4-9-315(1)) provides for the survival only of perfected security interests in goods that are confused or commingled, Arkansas Statute 85-9-312(2) (A.C.A. § 4-9-312(2)) provides that a security interest in products is continuously perfected if the interest in the original collateral was perfected. The continuity of perfection as to both original collateral and products thereof is, however, subject to the provisions of Act 16 of the Second Extraordinary Session of 1986, compiled as Arkansas Statute 85-9-307(4) through (6) (A.C.A. § 4-9-307(4) through § 4-9-307(6)), which is not repealed or otherwise affected by this Act.

The purposes behind Arkansas Statute 85-9-312(2) (A.C.A. § 4-9-312(2)) could be frustrated by typically unbargained-for, boilerplate language in loan agreements that could be construed to prohibit a debtor from creating production money security interests. So this sort of language is neutered. A creditor should not be allowed through contract to accomplish a result that contravenes the policy of positive law.

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\*The Arkansas General Assembly included this commentary in the adoption of Acts 1987, No. 560, § 2. It is unclear what legal effect formal adoption of this commentary may have on the interpretation of this section. The Arkansas General Assembly, by Acts 1989, No. 654, §§ 1, 3, repealed (2)(e) and amended (2)(f). The commentary adopted by the Arkansas General Assembly in 1987 by Acts 1987, No. 560, § 2, has not been amended to reflect the 1989 amendments.

### 1972 Official Comment to § 9-313 (A.C.A. § 4-9-313)\*

*Prior Uniform Statutory Provision:* Section 7, Uniform Conditional Sales Act.

*Purposes:*

1. Section 9-313 (A.C.A. § 4-9-313) deals with the problem that certain goods which are the subject of chattel financing become so affixed or otherwise so related to real estate that they become part of the real estate, and that chattel interests would be subordinate to real estate interests except as protected by the priorities regulated by the section. These goods are called "fixtures". Some fixtures also retain their chattel nature in that a chattel financing with respect to them may exist and may continue to be recognized, if notice thereof is given to real estate interests in accordance with this section. But this concept does not apply if the goods are integrally incorporated into the real estate.

The term "fixture filing" has been introduced and defined. It emphasizes that when a filing is intended to give the priority advantages herein discussed against real estate interests, the filing must (except as stated below) be for record in the real estate records and indexed therein, so

that it will be found in a real estate search.

Since the determination in advance of judicial decision of the question whether goods have become fixtures is a difficult one, no inference may be drawn from a fixture filing that the secured party concedes that the goods are or will become fixtures. The fixture filing may be merely precautionary.

2. "Fixture" is defined to include any goods which become so related to particular real estate that an interest in them arises under real estate law and therefore, goods integrally incorporated into the real estate are clearly fixtures. But under subsection (2) (A.C.A. § 4-9-313(2)) no security interest exists under Article 9 (Chapter 9) in ordinary building materials incorporated into an improvement on land.

Goods may be technically "ordinary building materials," e.g., window glass, but if they are incorporated into a structure which as a whole has not become an integral part of the real estate, the rules applicable to the ordinary building materials follow the rules applicable to the structure itself. The outstanding exam-



ples presenting this kind of problem are the modern "mobile homes" and the modern prefabricated steel buildings usable as warehouses, garages, factories, etc. In the case of the mobile homes, most of them are erected on leased land and the right of the debtor under a mobile home purchase contract to remove the goods as lessee will make clear that his secured party ordinarily has a similar right. See paragraph (5)(b) (A.C.A. § 4-9-313(5)(b)).

In cases where mobile homes or prefabricated steel buildings are erected by a person having an ownership interest in the land, the question into which category the buildings fall is one determined by local law. In general, the governing local law will not be that applicable in determining whether goods have become real property between landlord and tenant, or between mortgagor and mortgagee, or between grantor and grantee, but rather than applicable in a three-party situation, determining whether chattel financing can survive as against parties who acquire rights through the affixation of the goods to the real estate.

The assertion that no security interest exists in ordinary building materials is only for the operation of the priority provisions of this section. It is without prejudice to any rights which the secured party may have against the debtor himself if he incorporated the goods into real estate or against any party guilty of wrongful incorporation thereof in violation of the secured party's rights.

3. Under these concepts the section recognizes three categories of goods: (1) those which retain their chattel character entirely and are not part of the real estate; (2) ordinary building materials which have become an integral part of the real estate and cannot retain their chattel character for purposes of finance; and (3) an intermediate class which has become real estate for certain purposes, but as to which chattel financing may be preserved. This third and intermediate class is the primary subject of this section. The demarcation between these classifications is not delineated by this section.

4. In considering fixture priority problems, there will always first be a preliminary question whether real estate interests per se have an interest in the goods as part of real estate. If not, it is immaterial, so far as concerns real estate parties as

such, whether a chattel security interest is perfected or unperfected. In no event does a real estate party acquire an interest in a "pure" chattel just because a security interest therein is unperfected. If on the other hand real estate law gives real estate parties an interest in the goods, a conflict arises and this section states the priorities.

(a) The principal exception to the general rule of priority stated in Comment 4(b) based on time of filing or recording is a priority given in paragraph (4)(a) (A.C.A. § 4-9-313(4)(a)) to purchase money security interests in fixtures as against prior recorded real estate interests, provided that the purchase money security interest is filed as a fixture filing in the real estate records before the goods become fixtures or within 10 days thereafter. This priority corresponds to one given in Section 9-312(4) (A.C.A. § 4-9-312(4)), and the 10 days of grace represents a reduction of the purchase money priority as against prior interest in the real estate under the present Section 9-313 (A.C.A. § 4-9-313), where the purchase money priority exists even though the security interest is never filed.

It should be emphasized that this purchase money priority with the 10-day grace period for filing is limited to rights against prior real estate interests. There is no such priority with the 10-day grace period as against subsequent real estate interests. The fixture security interest can defeat subsequent real estate interests only if it is filed first and prevails under the usual conveyancing rule recognized in paragraph (4)(b) (A.C.A. § 4-9-313(4)(b)).

(b) The general principle of priority announced in this section is set forth in paragraph (4)(b) (A.C.A. § 4-9-313(4)(b)). It is basically that a fixture filing gives to the fixture security interest priority as against other real estate interests according to the usual priority rule of conveyancing, that is, the first to file or record prevails. An apparent limitation to this principle set forth in paragraph (4)(b) (A.C.A. § 4-9-313(4)(b)), namely that the secured party must have had priority over any interest of a predecessor in title of the conflicting encumbrancer or owner, is not really a limitation, but is an expression of the usual rule that a person must be entitled to transfer what he has. Thus, if the fixture security interest is subordinate

to a mortgage, it is subordinate to an interest of an assignee of the mortgage even though the assignment is a later recorded instrument. Similarly if the fixture security interest is subordinate to the rights of an owner, it is subordinate to a subsequent grantee of the owner and likewise subordinate to a subsequent mortgagee of the owner.

(c) A qualification to the rule based on priority of filing or recording is paragraph (4)(d) (A.C.A. § 4-9-313(4)(d)), where priority based on precedence in filing or recording is preserved, but there is no requirement that as against a judgment lienor of the real estate, the prior filing of the fixture security interest must be in the real estate records. The fixture security interest if perfected first should prevail even though not filed or recorded in real estate records, because generally a judgment creditor is not a reliance creditor who would have searched records. Thus, even a prior filing in the chattel records protects the priority of a fixture security interest against a subsequent judgment lien.

It is hoped that this rule will have the effect of preserving a fixture security interest so filed against invalidation by a trustee in bankruptcy. That would, of course, be the result under Section 60a of the Bankruptcy Act if the time of perfection of the fixture security interest were measured by the judgment creditor test applicable to personal property. It would not be the result if the time of perfection were measured by the purchaser test applicable to real estate. Since the fixture security interest arises against the goods in their capacity as chattels, the bankruptcy courts should apply the judgment creditor test. The effectiveness of the drafting to achieve its purpose cannot be known certainly until the courts adjudicate the question or until it is settled by amendment to Section 60a of the Bankruptcy Act.

The phrase "lien by legal or equitable proceedings" is suggested by Section 70c of the Bankruptcy Act, and is intended to encompass all liens on real estate obtained by any of the creditor action therein described.

(d) A special exception to the usual rule of priority based on precedence in time is the one of paragraph (4)(c) (A.C.A. § 4-9-313(4)(c)) in favor of holders of security

interests in factory and office machines, and in certain replacement domestic appliances, as discussed below. This is not as broad an exception as it might seem. To repeat, a fixture conflict is not reached if the goods are held as a matter of local law not to have become part of the real estate, which will frequently be the holding for goods of these types. If the opposite is held, the rule of paragraph (4)(c) (A.C.A. § 4-9-313(4)(c)) operates only if the fixture security interest is perfected before the goods become fixtures. Having been perfected, it would of course have priority over subsequent real estate interests under the rule of paragraph (4)(b) (A.C.A. § 4-9-313(4)(b)). Since it would in almost all cases be a purchase money security interest, it would also have priority over other real estate interests under the purchase-money priority of paragraph (4)(a) (A.C.A. § 4-9-313(4)(a)), discussed in paragraph (a) above. The rule is stated separately because the permitted perfection is by any method permitted by the Article (Chapter), and not exclusively by fixture filing in the real estate records. This rule is made necessary by the confusions of the law as to whether certain machinery and appliances become fixtures.

As an additional point, in the case of machinery, the separate statement of this rule makes clear that it is not overridden by the construction mortgage priority of subsection (6) (A.C.A. § 4-9-313(6)) discussed in Comment 4(e) below, as would have been true if reliance had been solely on the purchase-money priority. Factory and office machines are not always financed as part of a construction mortgage, and the mortgagee should be alert to conflicting chattel financing of these machines.

As to appliances, the rule stated is limited to readily removable replacements, not original installations, of appliances which are consumer goods in the hands of the debtor (Section 9-109 (A.C.A. § 4-9-109)). To facilitate financing of original appliances in new dwellings as part of the real estate financing of the dwellings, no special priority is given to chattel financing of original appliances. The section leaves to other law of the state the question whether original installations are fixtures to which the protection accorded by this section to construction mortgages



would be applicable. Likewise, it is recognized that (when not supplied by tenants) appliances in commercial apartment buildings are intended as permanent improvements, and no special rule is stated for appliances in that case. The special priority rule here stated in favor of chattel financing is limited to situations where the installation of appliances may not be intended to be permanent, i.e., replacement appliances used by the debtor or his family (consumer goods). The principal effect of the rule is to make clear that a secured party financing occasional replacements of domestic appliances in non-commercial owner-occupied contexts need not concern himself with real estate descriptions or records; indeed, for a purchase-money replacement of consumer goods, perfection without any filing will be possible. (The priority of the construction mortgage has no application to replacement appliances.)

(e) The purchase money priority presents a difficult problem in relation to construction mortgages. The latter will ordinarily have been recorded even before the commencement of delivery of materials to the job, and therefore would be prior in rank to the fixture security interests were it not for the problem of the purchase money priority. Subsection (6) (A.C.A. § 4-9-313(6)) expressly gives priority to the construction mortgage recorded before the filing of the fixture security interest, but this priority of a construction mortgage applies only during the construction period leading to the completion of the improvement. As to additions to the building made long after completion of the improvement, the construction priority will not apply simply because the additions are financed by the real estate mortgagee under an open end clause of his construction mortgage. In such case, the applicable principles will be those of paragraphs (4)(a) (A.C.A. § 4-9-313(4)(a)) and (4)(b) (A.C.A. § 4-9-313(4)(b)). A refinancing of a construction mortgage has the same priority as the mortgage itself.

The phrase "an obligation incurred for the construction of an improvement" covers both optional advances and advances pursuant to commitment, and both types of advances have the same priority under the section.

5. The section makes it impossible for a fixture supplier to retain a security inter-

est against a contractor, to the possible surprise and deception of real estate interests, unless the debtor has an interest of record in the real estate. See paragraphs (4)(a) (A.C.A. § 4-9-313(4)(a)) and (b) (A.C.A. § 4-9-313(4)(b)).

On the other hand, these paragraphs do recognize that fixture filing may be necessary when the debtor is in possession of the real estate (e.g., a lessee) even without an interest of record. This possibility of a filing against a debtor who is not in the real estate chain of title makes it necessary to require the furnishing of the name of a record owner in such cases. See Sections 9-402(3) (A.C.A. § 4-9-402(3)), item 3; 9-402(5) (A.C.A. § 4-9-402(5)); 9-403(7) (A.C.A. § 4-9-403(7)).

6. The status of fixtures installed by tenants (as well as such persons as licensees and holders of easements) is defined by paragraph (5)(b) (A.C.A. § 4-9-313(5)(b)) to the effect that if the debtor (tenant or other interest mentioned) has the right to remove the fixture as against a real estate interest, the secured party has priority over that real estate interest.

7. Real estate lenders and title companies will have little difficulty in locating relevant fixture security interests applicable to particular parcels of real estate because of the provisions as to real estate description in fixture filings, the indexing thereof, and other related provisions in Part 4 of Article 9 (Chapter 9).

8. Real estate lending is typically long-term, and is usually done by institutional investors who can afford to take a long view of the matter rather than concentrating on the results of any particular case. It is apparent that the rule which permits and encourages purchase money fixture financing, which in contrast is typically short-term, will result in the modernization and improvement of real estate rather than in its deterioration and will on balance benefit long-term real estate lenders. Because of the short-term character of the chattel financing, it will rarely produce any conflict in fact with the real estate lender. The contrary rule would chill the availability of short-term credit for modernization of real estate by installation of new fixtures and in the long run could not help real estate lenders.

9. Subsection (8) (A.C.A. § 4-9-313(8)) is an important departure from Section 7 of the Uniform Conditional Sales Act and

from much other conditional sales legislation. Under the Uniform Conditional Sales Act a conditional vendor could not sever and remove the affixed chattel if a "material injury to the freehold" would result. The courts of various jurisdictions were in sharp disagreement of the meaning of "material injury": some held that only physical injury was meant; others adopted the so-called "institutional theory" and denied removal whenever the "going value" of the structure would be materially diminished by the removal. Under these rules the conditional vendor either could not remove at all, or, if he could, could damage the structure on removal without becoming accountable to the real estate claimant. The situation was complicated by the fact that it became increasingly difficult to predict what types of goods the courts in a given jurisdiction would hold not subject to removal.

Subsection (8) (A.C.A. § 4-9-313(8)) abandons the "material injury to the freehold" rule. Instead a secured party entitled to priority may in all cases sever and remove his collateral, subject, however, to a duty to reimburse any real estate claimant (other than the debtor himself) for any physical injury caused by the removal. The right to reimbursement is implemented by the last sentence of subsection (8) (A.C.A. § 4-9-313(8)) which gives the real estate claimant a statutory right to security or indemnity failing which he may refuse permission to remove. The subsection (8) (A.C.A. § 4-9-313(8)) rule thus accomplishes two things: it puts an end to the uncertainty which has grown up under the "material injury" rule, while at the same time it protects the real estate claimant under the reimbursement provisions.

#### *Cross References:*

Sections 2-107 (A.C.A. § 4-2-107), 9-102(1) (A.C.A. § 4-9-102(1)), 9-104(j) (A.C.A. § 4-9-104(j)) and 9-312(1) (A.C.A. § 4-9-312(1)), and Parts 4 and 5.

#### *Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Encumbrance". Section 9-105 (A.C.A. § 4-9-105).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Mortgage". Section 9-105 (A.C.A. § 4-9-105).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-313), to incorporate the 1972 changes to this Uniform Commercial Code section.

### **1972 Official Comment to § 9-314 (A.C.A. § 4-9-314)\***

*Prior Uniform Statutory Provision:* None.

#### *Purposes:*

1. To state when a secured party claiming an interest in goods installed in or affixed to other goods is entitled to priority over a party with a security interest in the whole.

2. This section changes prior law in that the secured party claiming an interest in a part (e.g., a new motor in an old

car) is entitled to priority and has a right to remove even though under other rules of law the part now belongs to the whole.

3. This section does not apply to goods which, for example, are so commingled in a manufacturing process that their original identity is lost. That type of situation is covered in Section 9-315 (A.C.A. § 4-9-315). Section 9-315 (A.C.A. § 4-9-315) should also be consulted for the effect of a



financing statement which claims both component parts and the resulting product.

*Cross References:*

Sections 9-203(1) (A.C.A. § 4-9-203(1)), 9-303 (A.C.A. § 4-9-303) and 9-312(1) (A.C.A. § 4-9-312(1)) and Part 5.

Point 3: Section 9-315 (A.C.A. § 4-9-315).

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Creditor". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1967, No. 303, § 31, to correct a spelling error in the original enactments made by the Arkansas General Assembly. The arrangement of subdivision (3)(c) differs from the Uniform Commercial Code section.

**1972 Official Comment to § 9-315 (A.C.A. § 4-9-315)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. To state when a secured party whose collateral contributes to a product has priority over others who have conflicting claims in the same product.

2. This section changes the law in some jurisdictions where a security interest in goods (e.g., raw materials) was lost when the goods lost their identity by being commingled or processed. Under this section the security interest continues in the resulting mass or product in the cases stated in subsection (1) (A.C.A. § 4-9-315(1)).

3. This section applies not only to cases where flour, sugar and eggs are commingled into cake mix or cake, but also to cases where components are assembled into a machine. In the latter case a secured party is put to an election at the time of filing, by the last sentence of

subsection (1) (A.C.A. § 4-9-315(1)), whether to claim under this section or to claim a security interest in one component under Section 9-314 (A.C.A. § 4-9-314).

4. Subsection (2) (A.C.A. § 4-9-315(2)) is new and is needed because under subsection (1) (A.C.A. § 4-9-315(1)) it is possible to have more than one secured party claiming an interest in a product. The rule stated treats all such interests as being of equal priority entitled to share ratably in the product.

*Cross References:*

Sections 9-203(1) (A.C.A. § 4-9-203(1)), 9-303 (A.C.A. § 4-9-303), 9-312(1) (A.C.A. § 4-9-312(1)) and 9-314 (A.C.A. § 4-9-314).

*Definitional Cross References:*

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

**1972 Official Comment to § 9-316 (A.C.A. § 4-9-316)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

The several preceding sections deal elaborately with questions of priority. This section is inserted to make it entirely clear that a person entitled to priority may effectively agree to subordinate his

claim. Only the person entitled to priority may make such an agreement; his rights cannot be adversely affected by an agreement to which he is not a party.

*Cross References:*

Sections 1-102 (A.C.A. § 4-1-102) and 9-312(1) (A.C.A. § 4-9-312(1)).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

**1972 Official Comment to § 9-317 (A.C.A. § 4-9-317)**

*Prior Uniform Statutory Provision:* Section 12, Uniform Trust Receipts Act.

*Purposes:*

There were a few common law decisions, mostly in cases involving trust receipts, which suggested, if they did not hold, that a secured party who gave his debtor liberty of sale might be liable (for example, for breach of warranty) on the debtor's contracts of sale. The theory was grounded on the law of agency; the debtor being regarded as selling agent for the secured party as principal. This section rejects that theory. Section 12 of the Uniform Trust Receipts Act provided that the entruster was not subject to liability, merely because of his status as entruster,

on sale of the goods subject to trust receipt. This section adopts the policy of the prior act and states it in general terms.

*Cross Reference:*

Section 2-210(4) (A.C.A. § 4-2-210(4)).

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

**1972 Official Comment to § 9-318 (A.C.A. § 4-9-318)\***

*Prior Uniform Statutory Provision:* Section 9(3), Uniform Trust Receipts Act.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-9-318(1)) makes no substantial change in prior law. An assignee has traditionally been subject to defenses or setoffs existing before an account debtor is notified of the assignment. When the account debtor's defenses on an assigned claim arise from the contract between him and the assignor, it makes no difference whether the breach giving rise to the defense occurs before or after the account debtor is notified of the assignment (paragraph (1)(a) (A.C.A. § 4-9-318(1)(a))). The account debtor may also have claims against the assignor which arise independently of that contract: an assignee is subject to all such claims which accrue before, and free of all those which accrue after, the account debtor is notified (paragraph (1)(b) (A.C.A. § 4-9-318(1)(b))). The account debtor may waive his right to assert claims or defenses against an assignee to the extent provided in Section 9-206 (A.C.A. § 4-9-206).

2. Prior law was in confusion as to whether modification of an executory contract by account debtor and assignor without the assignee's consent was possible

after notification of an assignment. Subsection (2) (A.C.A. § 4-9-318(2)) makes good faith modifications by assignor and account debtor without the assignee's consent effective against the assignee even after notification. This rule may do some violence to accepted doctrines of contract law. Nevertheless it is a sound and indeed a necessary rule in view of the realities of large scale procurement. When for example it becomes necessary for a government agency to cut back or modify existing contracts, comparable arrangements must be made promptly in hundreds and even thousands of subcontracts lying in many tiers below the prime contract. Typically the right to payments under these subcontracts will have been assigned. The government, as sovereign, might have the right to amend or terminate existing contracts apart from statute. This subsection gives the prime contractor (the account debtor) the right to make the required arrangements directly with his subcontractors without undertaking the task of procuring assents from the many banks to whom rights under the contracts may have been assigned. Assignees are protected by the provision which gives them automatically corresponding rights under the modified or substituted contract. No-



tice that subsection (2) (A.C.A. § 4-9-318(2)) applies only so far as the right to payment has not been earned by performance, and therefore its application ends entirely when the work is done or the goods furnished.

3. Subsection (3) (A.C.A. § 4-9-318(3)) clarifies the right of an account debtor to make payment to his seller-assignor in an "indirect collection" situation (see Comment to Section 9-308 (A.C.A. § 4-9-308)). So long as the assignee permits the assignor to collect claims or leaves him in possession of chattel paper which does not indicate that payment is to be made at some place other than the assignor's place of business, the account debtor may pay the assignor even though he may know of the assignment. In such a situation an assignee who wants to take over collections must notify the account debtor to make further payments to him.

4. Subsection (4) (A.C.A. § 4-9-318(4)) breaks sharply with the older contract doctrines by denying effectiveness to contractual terms prohibiting assignment of sums due and to become due under contracts of sale, construction contracts and the like. Under the rule as stated, an assignment would be effective even if made to an assignee who took with full knowledge that the account debtor had sought to prohibit or restrict assignment of the claims.

It is only for the past hundred years that our law has recognized the possibility of assigning choses in action. The history of this development, at law and equity, is in broad outline well known. Lingering traces of the absolute common law prohibition have survived almost to our own day.

There can be no doubt that a term prohibiting assignment of proceeds was effective against an assignee with notice through the nineteenth century and well into the twentieth. Section 151 of the Restatement of Contracts (1932) so states the law without qualification, but the changing character of the law is shown in the proposed Section 154 of the Restatement, Second, Contracts.

The original rule of law has been progressively undermined by a process of erosion which began much earlier than the cited section of the Restatement of Contracts would suggest. The cases are legion in which courts have construed the

heart out of prohibitory or restrictive terms and held the assignment good. The cases are not lacking where courts have flatly held assignments valid without bothering to construe away the prohibition. See 4 Corbin on Contracts (1951) §§ 872, 873. Such cases as *Allhusen v. Caristo Const. Corp.*, 303 N.Y. 446, 103 N.E.2d 891 (1952), are rejected by this subsection.

This gradual and largely unacknowledged shift in legal doctrine has taken place in response to economic need; as accounts and other rights under contracts have become the collateral which secures an ever increasing number of financing transactions, it has been necessary to reshape the law so that these intangibles, like negotiable instruments and negotiable documents of title, can be freely assigned.

Subsection (4) (A.C.A. § 4-9-318(4)) thus states a rule of law which is widely recognized in the cases and which corresponds to current business practices. It can be regarded as a revolutionary departure only by those who still cherish the hope that we may yet return to the views entertained some two hundred years ago by the Court of King's Bench.

5. The Federal Assignment of Claims Act of 1940 — to which of course this section is subject — requires that assignments of claims against the United States be filed as provided in that Act. Many large business enterprises, situated like the United States in that claims against them are held by hundreds or thousands of subcontractors or suppliers, often require in their contract or purchase order forms that assignments against them be filed in a prescribed way. Subsection (3) (A.C.A. § 4-9-318(3)) requires reasonable identification of the account assigned and recognizes the right of an account debtor to require reasonable proof of the making of the assignment and to that extent validates such requirements in contracts or purchase order forms. If the notification does not contain such reasonable identification or if such reasonable proof is not furnished on request, the account debtor may disregard the assignment and make payment to the assignor. What is "reasonable" is not left to the arbitrary decision of the account debtor; if there is doubt as to the adequacy either of a notification or of proof submitted after request, the account

debtor may not be safe in disregarding it unless he has notified the assignee with commercial promptness as to the respects in which identification or proof is considered defective.

6. If the thing to be assigned is the beneficiary's right under a letter of credit, Section 5-116 (A.C.A. § 4-5-116) should be consulted.

*Cross References:*

Point 1: Section 9-206 (A.C.A. § 4-9-206).

Point 3: Sections 9-205 (A.C.A. § 4-9-205) and 9-308 (A.C.A. § 4-9-308).

Point 4: Section 2-210(2) (A.C.A. § 4-2-210(2)) and (3) (A.C.A. § 4-2-210(3)).

Point 6: Section 5-116 (A.C.A. § 4-5-116).

*Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Account debtor". Section 9-105 (A.C.A. § 4-9-105).

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Receives notification". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Section 2-106 (A.C.A. § 4-2-106) and 9-105 (A.C.A. § 4-9-105).

"Seasonably". Section 1-204 (A.C.A. § 4-1-204).

"Term". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-318), to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-401 (A.C.A. § 4-9-401)\***

*Prior Uniform Statutory Provision:* Section 4, Uniform Trust Receipts Act; Sections 6 and 7, Uniform Conditional Sales Act.

*Purposes:*

1. Under chattel mortgage acts, the Uniform Conditional Sales Act and other conditional sales legislation the geographical unit for filing or recording was local: the county or township in which the mortgagor or vendee resided or in which the goods sold or mortgaged were kept. The Uniform Trust Receipts Act used the state as the geographical filing unit: under that Act statements of trust receipt financing were filed with an official in the state capital and were not filed locally. The state-wide filing system of the Trust Receipts Act has been followed in many accounts receivable and factor's lien acts.

Both systems have their advocates and both their own advantages and drawbacks. The principal advantage of state-wide filing is ease of access to the credit information which the files exist to provide. Consider for example the national distributor who wishes to have current information about the credit standing of the thousands of persons he sells to on credit. The more completely the files are

centralized on a state-wide basis, the easier and cheaper it becomes to procure credit information; the more the files are scattered in local filing units, the more burdensome and costly. On the other hand, it can be said that most credit inquiries about local businesses, farmers and consumers come from local sources; convenience is served by having the files locally available and there is not great advantage in centralized filing.

This section does not attempt to resolve the controversy between the advocates of a completely centralized state-wide filing system and those of a large degree of local autonomy. Instead the section is drafted in a series of alternatives; local considerations of policy will determine the choice to be made.

2. Fortunately there is general agreement that the proper filing place for security interests in fixtures is in the office where a mortgage on the real estate concerned would be filed or recorded, and paragraph (1)(a) in the First Alternative and paragraph (1)(b) (A.C.A. § 4-9-401(1)(b)) in the Second and Third Alternatives so provide. This provision follows the Uniform Conditional Sales Act. Note that there is no requirement for an additional filing with the chattel records.



3. In states where it is felt wise to preserve local filing for transactions of essentially local interest, either the Second or Third Alternative of subsection (1) (A.C.A. § 4-9-401(1)) should be adopted. Paragraph (1)(a) (A.C.A. § 4-9-401(1)(a)) in both alternatives provides county (township, etc.) filing for consumer goods transactions and for agricultural transactions (farm equipment, farm products, farm accounts and crops). Note that the subsection departs from Section 6 of the Uniform Conditional Sales Act and adopts instead the policy of many chattel mortgage acts in selecting the county of the debtor's residence, rather than the county where the goods are located, as the normal filing place. Where, however, the debtor is an out-of-state resident, the filing must of necessity be in the county where the goods are, and the subsection so provides. Though not expressly stated, it is evident that filing for an assignment of accounts arising from the sale of farm products by a farmer who is not a resident must be in the county where the debtor keeps his farm products. In the case of crops growing or to be grown, where the land is in one county and the debtor's residence in another, filing must be made in both counties. Neither this filing for crops in the county where the land is nor the requirements that the security agreement (Section 9-203(1)(a) (A.C.A. § 4-9-203(1)(a))) and the financing statement (Section 9-402(1) (A.C.A. § 4-9-402(1)) and (3) (A.C.A. § 4-9-402(3))) contain a description of the real estate point to the conclusion that a financing statement for a security interest in crops must be filed in the real estate records. This Article (Chapter) follows pre-Code law which recognized such a financing as a chattel mortgage. The policy of the subsection is to require filing in the place or places where a creditor would normally look for information concerning interests created by the debtor.

For some incorporated farmers, reference to residence is an anomaly. Therefore subsection (6) (A.C.A. § 4-9-401(6)) provides that the residence of an organization is its place of business, or its chief executive office if it has more than one place of business. Compare Section 9-103(3) (A.C.A. § 4-9-103(3)), which reaches essentially the same concept as a definition of the "location" of a debtor.

4. It is thought that sound policy requires a state-wide filing system for all transactions except the essentially local ones covered in paragraph (1)(a) (A.C.A. § 4-9-401(1)(a)) of the Second and Third Alternatives and land-related transactions covered in paragraph (1)(b) (A.C.A. § 4-9-401(1)(b)) of the Second and Third Alternatives. Paragraph (1)(c) (A.C.A. § 4-9-401(1)(c)) so provides in both alternatives, as does paragraph (1)(b) in the First Alternative. In a state which has adopted either the Second or Third Alternative, central filing would be required when the collateral was goods except consumer goods, farm equipment or farm products (including crops), or was documents or chattel paper or was accounts or general intangibles unless related to a farm. Note that the filing provisions of this Article (Chapter) do not apply to instruments (see Section 9-304 (A.C.A. § 4-9-304)).

If the Third Alternative subsection (1) (A.C.A. § 4-9-401(1)) is adopted, then local filing, in addition to the central filing, is required in all the cases stated in the preceding paragraph, with respect to any debtor whose places of business within the state are all within a single county (township, etc.) or a debtor who is not engaged in business. The last event test stated in Section 9-103(1)(b) (A.C.A. § 4-9-103(1)(b)) and Comment thereto applies to determine whether local filing is required under the present section, as well as to determine in which state filing is required.

In states where the arguments for a completely centralized set of files (except for fixtures) prevail, the First Alternative subsection (1) should be adopted. That alternative provides for exclusive central filing of all security interests except those in fixtures.

5. When a secured party has in good faith attempted to comply with the filing requirements but has not done so correctly, subsection (2) (A.C.A. § 4-9-401(2)) makes his filing effective insofar as it was proper, and also makes it good for all collateral covered by the financing statement against any person who actually knows the contents of the improperly filed statement. The subsection rejects the occasional decisions that an improperly filed record is ineffective to give notice even to a person who knows of it. But if the Third

Alternative subsection (1) (A.C.A. § 4-9-401(1)) is adopted, the requirements of paragraph (1)(c) (A.C.A. § 4-9-401(1)(c)) are not complied with unless there is filing in both offices specified; filing in only one of two required places is not effective except as against one with actual knowledge of the contents of the defective financing statement.

6. Subsection (3) (A.C.A. § 4-9-401(3)) deals with change of residence or place of business or the location or use of the goods after a proper filing has been made. The subsection is important only when local filing is required, and covers only changes between local filing units in the state. For changes of location between states see Section 9-103(1)(d) (A.C.A. § 4-9-103(1)(d)).

Subsection (3) (A.C.A. § 4-9-401(3)) is presented in alternative forms. Under the first, no new filing is required in the county to which the collateral has been removed. Under alternative subsection (3) (A.C.A. § 4-9-401(3)) the original filing lapses four months after the change in location; this is basically the same rule that is applied by Section 9-103(1)(d) (A.C.A. § 4-9-103(1)(d)) to the case of collateral brought into the state subject to a security interest which attached elsewhere.

7. The usual filing rules do not apply well for a transmitting utility (defined in Section 9-105 (A.C.A. § 4-9-105)). Many pre-Code statutes provided special filing rules for railroads and in some cases for other public utilities to avoid the requirements for filing with legal descriptions in every county in which such debtors had property. The Code recreates and broadens these provisions by subsection (5) (A.C.A. § 4-9-401(5)) of this section, which provides that for transmitting utilities the filing need only be in the office of the Secretary of State. The nature of the debtor will inform persons searching the record as to where to make a search.

#### *Cross References:*

Sections 9-302 (A.C.A. § 4-9-302), 9-304

(A.C.A. § 4-9-304) and 9-307(2) (A.C.A. § 4-9-307(2)).

Point 2: Section 9-313 (A.C.A. § 4-9-313).

Point 6: Section 9-103(3) (A.C.A. § 4-9-103(3)).

Point 7: Sections 9-402(5) (A.C.A. § 4-9-402(5)) and 9-403(6) (A.C.A. § 4-9-403(6)).

#### *Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Consumer goods". Section 9-109 (A.C.A. § 4-9-109).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Equipment". Section 9-109 (A.C.A. § 4-9-109).

"Farm products". Section 9-109 (A.C.A. § 4-9-109).

"Financing statement". Section 9-402 (A.C.A. § 4-9-402).

"Fixture filing". Section 9-313 (A.C.A. § 4-9-313).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Transmitting utility". Section 9-105 (A.C.A. § 4-9-105).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-401), to incorporate the 1972 changes to this Uniform Commercial Code section.



**1972 Official Comment to § 9-402 (A.C.A. § 4-9-402)\***

*Prior Uniform Statutory Provision:* Sections 13(3), 13(4), Uniform Trust Receipts Act.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-9-402(1)) sets out the simple formal requisites of a financing statement under this Article (Chapter). These requirements are: (1) signature of the debtor; (2) addresses of both parties; (3) a description of the collateral by type or item.

Where the collateral is crops growing or to be grown or when the financing statement is filed as a fixture filing (Section 9-313 (A.C.A. § 4-9-313)) or when the collateral is timber to be cut or minerals or the like (including oil and gas) financed at wellhead or minehead or accounts resulting from the sale thereof, the financing statement must also contain a description of the lands concerned. On description generally, see Section 9-110 (A.C.A. § 4-9-110) and Comment 5 to the present section. An important distinction must be drawn, however, between the function of the description of land in reference to crops and its function in the other cases mentioned. For crops it is merely part of the description of the crops concerned, and the security interest in crops is a Code security interest, like the pre-Code "crop mortgage" which was a chattel mortgage. In contrast, in the other cases mentioned the function of the description of land is to have the financing statement filed in the county where the land is situated and in the realty records, as distinguished from the chattel records. Subsection (3) (A.C.A. § 4-9-402(3)) suggests a form which complies with the statutory requirements and makes clear that for the types of collateral mentioned other than crops, the financing statement containing a description of the land concerned is to go in the realty records. Note also subsection (5) (A.C.A. § 4-9-402(5)) on the adequacy of the description of land where the filing is to be in the real estate records. See also Section 9-403(7) (A.C.A. § 4-9-403(7)) on the indexing of these filings in the real estate records.

A copy of the security agreement may be filed in place of a separate financing statement, if it contains the required information and signature.

2. This section adopts the system of "notice filing" which proved successful under the Uniform Trust Receipts Act. What is required to be filed is not, as under chattel mortgage and conditional sales acts, the security agreement itself, but only a simple notice which may be filed before the security interest attaches or thereafter. The notice itself indicates merely that the secured party who has filed may have a security interest in the collateral described. Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs. Section 9-208 (A.C.A. § 4-9-208) provides a statutory procedure under which the secured party, at the debtor's request, may be required to make disclosure. Notice filing has proved to be of great use in financing transactions involving inventory, accounts and chattel paper, since it obviates the necessity of refileing on each of a series of transactions in a continuing arrangement where the collateral changes from day to day. Where other types of collateral are involved, the alternative procedure of filing a signed copy of the security agreement may prove to be the simplest solution. Sometimes more than one copy of a financing statement or of a security agreement used as a financing statement is needed for filing. In such a case the section permits use of a carbon copy or photographic copy of the paper, including signatures.

However, even in the case of filings that do not necessarily involve a series of transactions the financing statement is effective to encompass transactions under a security agreement not in existence and not contemplated at the time the notice was filed, if the description of collateral in the financing statement is broad enough to encompass them. Similarly, the financing statement is valid to cover after-acquired property and future advances under security agreements whether or not mentioned in the financing statement.

3. This section departs from the requirements of many pre-Code chattel mortgage statutes that the instrument filed be acknowledged or witnessed or accompanied by affidavits of good faith. Those requirements did not seem to have been successful as a deterrent to fraud;

their principal effect was to penalize good faith mortgagees who had inadvertently failed to comply with the statutory niceties. They are here abandoned in the interest of a simplified and workable filing system.

4. Subsection (2) (A.C.A. § 4-9-402(2)) allows the secured party to file a financing statement signed only by himself where the filing is required by any of the events listed, each of which occurs after the commencement of the financing, and therefore under circumstances where the cooperation of the debtor is not certain. Section 9-401(3) (A.C.A. § 4-9-401(3)), alternative provision, contains similar permission on removal between counties in this state. The secured party should not be penalized for failure to make a timely filing by reason of difficulty in procuring the signature of a possibly reluctant or hostile debtor. Financing statements filed under this subsection must explain the circumstances under which they are filed with the signature of the secured party rather than that of the debtor.

In contrast to the signatures on original financing statements, an amendment to a financing statement must be signed by both parties, to preclude either from adversely affecting the interests of the other.

The reference in subsection (4) (A.C.A. § 4-9-402(4)) to an amendment which "adds collateral" refers to additional types of collateral. A security interest on additional units of a type of collateral already described can be created under an after-acquired property clause or a new security agreement. See Comment 5 to Section 9-204 (A.C.A. § 4-9-204). On priorities in such cases see Section 9-312 (A.C.A. § 4-9-312) and Comments thereto.

5. A description of real estate must be sufficient to identify it. See Section 9-110 (A.C.A. § 4-9-110). This formulation rejects the view that the real estate description must be by metes and bounds, or otherwise conforming to traditional real estate practice in conveyancing, but of course the incorporation of such a description by reference to the recording data of a deed, mortgage or other instrument containing the description should suffice under the most stringent standards. The proper test is that a description of real estate must be sufficient so that the fixture financing statement will fit into the real estate search system and the financ-

ing statement be found by a real estate searcher. Optional language has been added by which the test of adequacy of the description is whether it would be adequate in a mortgage of the real estate. As suggested in the Note, more detail may be required if there is a tract indexing system or a land registration system.

Where the debtor does not have an interest of record in the real estate, a fixture financing statement must show the name of a record owner, and Section 9-403(7) (A.C.A. § 4-9-403(7)) requires the financing statement to be indexed in the name of that owner. Thus the fixture financing statement will fit into the real estate search system.

6. A real estate mortgage may provide that it constitutes a security agreement with respect to fixtures (or other goods) in conformity with this Article (Chapter). Combined mortgages on real estate and chattels are common and useful for certain purposes. This section goes further and makes provision that the recording of the real estate mortgage (if it complies with the requirements of a financing statement) shall constitute the filing of a financing statement as to the fixtures (but not, of course, as to the other goods). Section 9-403(6) (A.C.A. § 4-9-403(6)) makes the usual five-year maximum life for financing statements inapplicable to real estate mortgages which operate as financing statements under Section 9-402(6) (A.C.A. § 4-9-402(6)), and they are effective for the duration of the real estate recording.

Of course, if a combined mortgage covers chattels which are not fixtures, a regular chattel filing is necessary, and subsection (6) (A.C.A. § 4-9-402(6)) is inapplicable to such chattels. Likewise, filing as a "fixture filing" provided in Section 9-401 (A.C.A. § 4-9-401) does not apply to true chattels.

7. Subsection (7) (A.C.A. § 4-9-402(7)) undertakes to deal with some of the problems as to who is the debtor. In the case of individuals, it contemplates filing only in the individual name, not in a trade name. In the case of partnerships it contemplates filing in the partnership name, not in the names of any of the partners, and not in any other trade names. Trade names are deemed to be too uncertain and too likely not to be known to the secured party or person searching the record, to



form the basis for a filing system. However, provision is made in Section 9-403(5) (A.C.A. § 4-9-403(5)) for indexing in a trade name if the secured party so desires.

Subsection (7) (A.C.A. § 4-9-402(7)) also deals with the case of a change of name of a debtor and provides some guidelines when mergers or other changes of corporate structure of the debtor occur with the result that a filed financing statement might become seriously misleading. Not all cases can be imagined and covered by statutes in advance; however, the principle sought to be achieved by the subsection is that after a change which would be seriously misleading, the old financing statement is not effective as to new collateral acquired more than four months after the change, unless a new appropriate financing statement is filed before the expiration of the four months. The old financing statement, if legally still valid under the circumstances, would continue to protect collateral acquired before the change and, if still operative under the particular circumstances, would also protect collateral acquired within the four months. Obviously the subsection does not undertake to state whether the old security agreement continues to operate between the secured party and the party surviving the corporate change of the debtor.

8. Subsection (7) (A.C.A. § 4-9-402(7)) also deals with a different problem, namely whether a new filing is necessary where the collateral has been transferred from one debtor to another. This question has been much debated both in pre-Code law and under the Code. This Article (Chapter) now answers the question in the negative. Thus, any person searching the condition of the ownership of a debtor must make inquiry as to the debtor's source of title, and must search in the name of a former owner if circumstances seem to require it.

9. Subsection (8) (A.C.A. § 4-9-402(8)) is in line with the policy of this Article (Chapter) to simplify formal requisites and filing requirements and is designed to discourage the fanatical and impossibly refined reading of such statutory requirements in which courts have occasionally indulged themselves. As an example of the

sort of reasoning which this subsection rejects, see *General Motors Acceptance Corporation v. Haley*, 329 Mass. 559, 109 N.E.2d 143 (1952).

#### *Cross References:*

Point 1: Section 9-110 (A.C.A. § 4-9-110).

Point 2: Section 9-208 (A.C.A. § 4-9-208).

Point 4: Sections 9-103 (A.C.A. § 4-9-103), 9-306 (A.C.A. § 4-9-306) and 9-401(3) (A.C.A. § 4-9-401(3)).

Point 5: Section 9-110 (A.C.A. § 4-9-110).

Point 6: Section 9-403(6) (A.C.A. § 4-9-403(6)).

Point 7: Section 9-403(8).\*\*

Point 8: Section 9-311 (A.C.A. § 4-9-311).

#### *Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Fixture". Section 9-313 (A.C.A. § 4-9-313).

"Fixture filing". Section 9-313 (A.C.A. § 4-9-313).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Party". Section 1-201 (A.C.A. § 4-1-201).

"Proceeds". Section 9-306 (A.C.A. § 4-9-306).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Transmitting utility". Section 9-105 (A.C.A. § 4-9-105).

\*This section was amended by Acts 1973, No. 116, § 1 (9-402), to incorporate the 1972 changes to this Uniform Commercial Code section.

\*\*There is no Uniform Commercial Code subsection 9-403(8).

**1972 Official Comment to § 9-403 (A.C.A. § 4-9-403)\***

*Prior Uniform Statutory Provision:* Sections 13(3), 13(4), Uniform Trust Receipts Act; Section 10, Uniform Conditional Sales Act.

*Purposes:*

1. Prior law was not always clear whether a mortgage filed for record gave constructive notice from the time of presentation to the filing officer or only from the time of indexing. Subsection (1) (A.C.A. § 4-9-403(1)) adopts the former position.

2. Prior statutes have usually limited the effectiveness of a filing to a specified period of time after which refiling is necessary. Subsection (2) (A.C.A. § 4-9-403(2)) follows the same policy, establishing five years as the filing period, with an exception for the cases mentioned in subsection (6) (A.C.A. § 4-9-403(6)). Subsection (3) (A.C.A. § 4-9-403(3)) provides for the filing of one or more continuation statements (which need be signed only by the secured party) if it is desired to continue the effectiveness of the original filing.

The theory of this Article (Chapter) is that the public files of financing statements are self-clearing, because the filing officer may automatically discard each financing statement after a period of five years plus the year after lapse required by subsection (3) (A.C.A. § 4-9-403(3)), unless a continuation statement is filed, or the financing statement is still effective under subsection (6) (A.C.A. § 4-9-403(6)). This theory materially lessens the tension that would otherwise exist to have the files cleared by termination statements under Section 9-404 (A.C.A. § 4-9-404). Similarly, a person searching the files need not go back past this five years plus one year; and if the indices are arranged by years, he has a limited and defined search problem. The section asks the filing officer to attach financing statements whose life has been continued by continuation statements to the latter statements, so that anything contained in the files of old years can be discarded.

Subsection (6) (A.C.A. § 4-9-403(6)) provides certain special filing rules, namely, filings against transmitting utilities (Section 9-105 (A.C.A. § 4-9-105)), for which financing statements are filed in

the office of the [Secretary of State]; and real estate mortgages which serve as fixture financing statements and which are filed in the real estate records. In both of these cases the financing statement is valid for the life of the obligations secured. No confusion as to the required scope of search should result, because of the special nature of the filings involved.

3. Under subsection (2) (A.C.A. § 4-9-403(2)) the security interest becomes unperfected when filing lapses. Thereafter, the interest of the secured party is subject to defeat by purchasers and lienors even though before lapse the conflicting interest may have been junior. Compare the situation arising under Section 9-103(1)(d) (A.C.A. § 4-9-103(1)(d)) when a perfected security interest under the law of another jurisdiction is not perfected in this state within four months after the property is brought into this state.

Thus if A and B both make nonpurchase money advances against the same collateral, and both perfect security interests by filing, A who files first is entitled to priority under Section 9-312(5) (A.C.A. § 4-9-312(5)). But if no continuation statement is filed, A's filing may lapse first. So long as B's interest remains perfected thereafter, he is entitled to priority over A's unperfected interest. This rule avoids the circular priority which arose under some prior statutes, under which A was subordinate to the debtor's trustee in bankruptcy, A retained priority over B, and B's interest was valid against the trustee in bankruptcy. In *re Andrews*, 172 F.2d 996 (7th Cir. 1949).

4. Subsection (7) (A.C.A. § 4-9-403(7)) makes clear that the filings in real estate records (Sections 9-401 (A.C.A. § 4-9-401) and 9-402(3) (A.C.A. § 4-9-402(3)) and (5) (A.C.A. § 4-9-403(5))) shall be indexed in the real estate records, where they will be found by a real estate searcher. Where the debtor is not an owner of record, the financing statement must show the name of an owner of record, and the statement is to be indexed in his name. See Sections 9-313(4)(b) (A.C.A. § 4-9-313(4)(b)) and (c) (A.C.A. § 4-9-313(4)(c)); 9-402(3) (A.C.A. § 4-9-402(3)); 9-402(5) (A.C.A. § 4-9-402(5)).



*Cross References:*

Point 3: Sections 9-103(3) (A.C.A. § 4-9-103(3)), 9-301 (A.C.A. § 4-9-301) and 9-312(5) (A.C.A. § 4-9-312(5)).

Point 4: Sections 9-313(4)(b) (A.C.A. § 4-9-313(4)(b)) and (c) (A.C.A. § 4-9-313(4)(c)), 9-401(1) (A.C.A. § 4-9-401(1)), 9-402(3) (A.C.A. § 4-9-402(3)) and (5) (A.C.A. § 4-9-402(5)), 9-405(2) (A.C.A. § 4-9-405(2)).

*Definitional Cross References:*

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Financing statement". Section 9-402 (A.C.A. § 4-9-402).

"Fixture". Section 9-313 (A.C.A. § 4-9-313).

"Fixture filing". Section 9-313 (A.C.A. § 4-9-313).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Transmitting utility". Section 9-105 (A.C.A. § 4-9-105).

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\*This section was amended by: Acts 1967, No. 303, § 32, to accurately adopt the language of the Uniform Commercial Code section; Acts 1973, No. 116, § 1 (9-403), to incorporate the 1972 changes to this Uniform Commercial Code section; and Acts 1979, No. 998, § 1, to increase the fee amount to \$3.00 and vary the language from the Uniform Act section.

### 1972 Official Comment to § 9-404 (A.C.A. § 4-9-404)\*

*Prior Uniform Statutory Provision:* Section 12, Uniform Conditional Sales Act.

*Purposes:*

1. To provide a procedure for noting discharge of the secured obligation on the records and for noting that a financing arrangement has been terminated.

Since most financing statements expire in five years unless a continuation statement is filed (Section 9-403 (A.C.A. § 4-9-403)), no compulsion is placed on the secured party to file a termination statement unless demanded by the debtor, except in the case of consumer goods. Because many consumers will not realize the importance of clearing the situation as it appears on file, an affirmative duty is put on the secured party in that case. But many purchase money security interests in consumer goods will not be filed, except for motor vehicles (Section 9-302(1)(d) (A.C.A. § 4-9-302(1)(d))); and in the case of motor vehicles a certificate of title law may control instead of the provisions of Article 9 (Chapter 9).

2. This section adds to the usual provisions one covering the problem which arises because a secured party under a notice filing system may file notice of an intention to make advances which may never be made. Under this section a debtor may require a secured party to send a termination statement when there is no outstanding obligation and no commitment to make future advances.

*Cross Reference:*

Point 2: Section 9-402(1) (A.C.A. § 4-9-402(1)).

*Definitional Cross References:*

"Consumer goods". Section 9-109 (A.C.A. § 4-9-109).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Financing statement". Section 9-402 (A.C.A. § 4-9-402).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by: Acts 1967, No. 303, § 33, to add subsection (3), which was deleted from the original Arkansas enactment by the General Assembly; Acts 1973, No. 116, § 1, to incorporate the 1972 changes to this Uniform Commercial Code section; and Acts 1979, No. 998, § 1, to increase the fee to \$3.00.

**1972 Official Comment to § 9-405 (A.C.A. § 4-9-405)\***

*Prior Uniform Statutory Provision:* None.

*Purposes:*

This section provides a permissive device whereby a secured party who has assigned all or part of his interest may have the assignment noted of record. Note that under Section 9-302(2) (A.C.A. § 4-9-302(2)) no filing of such an assignment is required as a condition of continuing the perfected status of the security interest against creditors and transferees of the original debtor. A secured party who has assigned his interest might wish to have the fact noted of record, so that inquiries concerning the transaction would be addressed not to him but to the assignee (see Point 2 of Comment to Section 9-402 (A.C.A. § 4-9-402)). After a secured party has assigned his rights of record, the assignee becomes the "secured party of record" and may file a continuation statement under Section 9-403 (A.C.A. § 4-9-403), a termination statement under Section 9-404 (A.C.A. § 4-9-404), or a statement of release under Section 9-406 (A.C.A. § 4-9-406).

Where a mortgage of real estate is effective as a financing statement filed as a fixture filing (Section 9-402(6) (A.C.A. § 4-9-402(6))), then an assignment of

record of the security interest may be made only in the manner in which an assignment of the mortgage may be made under the local state law.

*Cross References:*

Sections 9-302(2) (A.C.A. § 4-9-302(2)) and 9-402 through 9-406 (A.C.A. §§ 4-9-402 through 4-9-406).

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Financing statement". Section 9-402 (A.C.A. § 4-9-402).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-405), to incorporate the 1972 changes to this Uniform Commercial Code section, and by Acts 1979, No. 998, § 1, to increase the fee to \$3.00.

**1972 Official Comment to § 9-406 (A.C.A. § 4-9-406)\***

*Prior Uniform Statutory Provision:* None.

*Purposes:*

Like the preceding section, this section provides a permissive device for noting of record any release of collateral. There is no requirement that such a statement be filed when collateral is released (cf. Section 9-404 (A.C.A. § 4-9-404) on Termination Statements). It is merely a method of making the record reflect the true state of affairs so that fewer inquiries will have to be made by persons who consult the files.

If the statement of release is not signed by the secured party of record, the assignment procedure of Section 9-405(2) (A.C.A. § 4-9-405(2)) must be followed.

*Cross Reference:*

Section 9-404 (A.C.A. § 4-9-404).

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Financing statement". Section 9-402 (A.C.A. § 4-9-402).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-406), to incorporate the 1972 changes to this Uniform Commercial Code section, and by Acts 1979, No. 998, § 1, to increase the fee to \$3.00.



**1972 Official Comment to § 9-407 (A.C.A. § 4-9-407)\***

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Subsection (1) (A.C.A. § 4-9-407(1)) requires the filing officer upon request to return to the secured party a copy of the financing statement on which the material data concerning the filing are noted. Receipt of such a copy will assure the secured party that the mechanics of filing have been complied with. Note, however, that under Section 9-403(1) (A.C.A. § 4-9-403(1)) the secured party does not bear the risk that the filing officer will not properly perform his duties: under that section the secured party has complied with the filing requirements when he presents his financing statement for filing and the filing fee has been tendered or the statement accepted by the filing officer.

2. Subsection (2) (A.C.A. § 4-9-407(2)) requires the filing officer on request to issue to any person who has tendered the proper fee his certificate as to what filings have been made against any particular debtor and to furnish copies of such filed financing statements. In view of the centralized filing system adopted by this Article (Chapter) (see Section 9-401 (A.C.A. § 4-9-401) and Comment thereto), this provision is of obvious convenience to a person who wishes to know what the files contain but who cannot conveniently consult files located in the state capitol.

*Cross References:*

Point 1: Section 9-403(1) (A.C.A. § 4-9-403(1)).

Point 2: Section 9-401 (A.C.A. § 4-9-401).

*Definitional Cross References:*

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Financing statement". Section 9-402 (A.C.A. § 4-9-402).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Send". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by: Acts 1973, No. 116, § 1 (9-407), to incorporate the 1972 changes to this Uniform Commercial Code section: Acts 1979, No. 998, § 1, to increase the filing fee; Acts 1986 (2nd Ex. Sess.), No. 16, § 2, to add subsections (3)-(7); and Acts 1987, No. 108, §§ 7, 11, to change the language of the section. Because of the numerous Arkansas amendments to this section, it does vary from the Uniform Commercial Code section and therefore the commentary may not apply.

**1972 Official Comment to § 9-408 (A.C.A. § 4-9-408)**

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. Where filing is required under Sections 2-326(3) (A.C.A. § 4-2-326(3)) and 9-114 (A.C.A. § 4-9-114) for a consignment which is not a security interest (Section 1-201(37) (A.C.A. § 4-1-201(37))), this section authorizes the appropriate adaptations of terminology.

Apart from the rules in Part 4, the rules of this article (chapter) using the terms "debtor" and "secured party" will not apply to consignments if they are not security interests. Section 9-114 (A.C.A. § 4-9-114) on consignments essentially parallels Section 9-312(3) (A.C.A. § 4-9-312(3)) on inventory priorities, and the latter rule therefore does not apply to consignments.

Section 2-326 states the rights of creditors of a consignee who has not filed or otherwise complied with subsection (3) (A.C.A. § 4-9-408(3)), and Section 9-301 (A.C.A. § 4-9-301) on unperfected security interests is therefore not applicable. Section 2-326 (A.C.A. § 4-2-326) and the law of consignments supply rules which are provided by Section 9-311 (A.C.A. § 4-9-311) for security interests and that section is therefore not applicable to consignments. For reasons indicated in the Comment to Section 9-114 (A.C.A. § 4-9-114) Section 9-306 (A.C.A. § 4-9-306) on proceeds is inapplicable to consignments. An equivalent to the protection of a buyer in ordinary course of business against a security interest under Section 9-307(1) (A.C.A. § 4-9-307(1)) is provided against consign-

ments by Section 2-403(2) (A.C.A. § 4-2-403(2)) and (3) (A.C.A. § 4-9-403(3)).

2. If a lease is actually intended as security (Section 1-201(37) (A.C.A. § 4-1-201(37))), this Article (Chapter) applies in full. But this question of intention is a doubtful one, and the lessor may choose to file for safety even while contending that the lease is a true lease for which no filing is required. This section authorizes filing

with appropriate changes of terminology, and without affecting the substantive question of classification of the lease. If the lease is a true lease, none of the provisions of the Article (Chapter) is applicable to the lease as an interest in the chattel. Note, however, that the Article (Chapter) may be applicable to the lease in its aspect as chattel paper. See Section 9-105(b) (A.C.A. § 4-9-105(b)).

### 1972 Official Comment to § 9-501 (A.C.A. § 4-9-501)\*

*Prior Uniform Statutory Provision:* Section 6, Uniform Trust Receipts Act; Sections 16 through 26, Uniform Conditional Sales Act.

#### *Purposes:*

1. The rights of the secured party in the collateral after the debtor's default are of the essence of a security transaction. These are the rights which distinguish the secured from the unsecured lender. This section and the following six sections state those rights as well as the limitations on their free exercise which legislative policy requires for the protection not only of the defaulting debtor but of other creditors. But subsections (1) (A.C.A. § 4-9-501(1)) and (2) (A.C.A. § 4-9-501(2)) make it clear that the statement of rights and remedies in this Part does not exclude other remedies provided by agreement.

2. Following default and the taking possession of the collateral by the secured party, there is no longer any distinction between the security interest which before default was non-possessory and that which was possessory under a pledge. Therefore no general distinction is taken in this Part between the rights of a non-possessory secured party and those of a pledgee; the latter, being in possession of the collateral at default, will of course not have to avail himself of the right to take possession under Section 9-503 (A.C.A. § 4-9-503).

3. Section 9-207 (A.C.A. § 4-9-207) states rights, remedies and duties with respect to collateral in the secured party's possession. That section applies not only to the situation where he is in possession before default, as a pledgee, but also, by subsections (1) (A.C.A. § 4-9-501(1)) and (2) (A.C.A. § 4-9-501(2)) of this section, to the secured party in possession after default. Nevertheless the relations of the

parties have been changed by default, and Section 9-207 (A.C.A. § 4-9-207) as it applies after default must be read together with this Part. In particular, agreements permitted under Section 9-207 (A.C.A. § 4-9-207) cannot waive or modify the rights of the debtor contrary to subsection (3) (A.C.A. § 4-9-501(3)) of this section.

4. Section 1-102(3) (A.C.A. § 4-1-102(3)) states rules to determine which provisions of this Act are mandatory and which may be varied by agreement. In general, provisions which relate to matters which come up between immediate parties may be varied by agreement. In the area of rights after default our legal system has traditionally looked with suspicion on agreements designed to cut down the debtor's rights and free the secured party of his duties: no mortgage clause has ever been allowed to clog the equity of redemption. The default situation offers great scope for over-reaching; the suspicious attitude of the courts has been grounded in common sense.

Subsection (3) (A.C.A. § 4-9-501(3)) of this section contains a codification of this longstanding and deeply rooted attitude: the specified rights of the debtor and duties of the secured party may not be waived or varied except as stated. Provisions not specified in subsection (3) (A.C.A. § 4-9-501(3)) are subject to the general rules stated in Section 1-102(3) (A.C.A. § 4-1-102(3)).

5. The collateral for many corporate security issues consists of both real and personal property. In the interest of simplicity and speed subsection (4) (A.C.A. § 4-9-501(4)) permits, although it does not require, the secured party to proceed as to both real and personal property in accordance with his rights and remedies in respect of the real property. Except for



the permission so granted, this Act leaves to other state law all questions of procedure with respect to real property. For example, this Act does not determine whether the secured party can proceed against the real estate alone and later proceed in a separate action against the personal property in accordance with his rights and remedies against the real estate. By such separate actions the secured party "proceeds as to both," and this Part does not apply in either action. But subsection (4) (A.C.A. § 4-9-501(4)) does give him an option to proceed under this Part as to the personal property.

6. Under subsection (1) (A.C.A. § 4-9-501(1)) a secured party is entitled to reduce his claim to judgment or to foreclose his interest by any available procedure, outside this Article (Chapter), which state law may provide. The first sentence of subsection (5) (A.C.A. § 4-9-501(5)) makes clear that any judgment lien which the secured party may acquire against the collateral is, so to say, a continuation of his original interest (if perfected) and not the acquisition of a new interest or a transfer of property to satisfy an antecedent debt. The judgment lien is therefore stated to relate back to the date of perfection of the security interest. The second sentence of the subsection makes clear that a judicial sale following judgment, execution and levy is one of the methods of foreclosure contemplated by subsection (1) (A.C.A. § 4-9-501(1)); such a sale is governed by other law and not by this Article (Chapter) and the restrictions which this Article (Chapter) imposes on the right of a secured party to buy in the

collateral at a sale under Section 9-504 (A.C.A. § 4-9-504) do not apply.

*Cross References:*

Point 2: Section 9-503 (A.C.A. § 4-9-503).

Point 3: Section 9-207 (A.C.A. § 4-9-207).

Point 4: Section 1-102(3) (A.C.A. § 4-1-102(3)).

Point 5: Sections 9-102(1) (A.C.A. § 4-9-102(1)) and 9-104(j) (A.C.A. § 4-9-104(j)).

Point 6: Section 9-504 (A.C.A. § 4-9-504).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Documents". Section 9-105 (A.C.A. § 4-9-105).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Remedy". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1, to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-502 (A.C.A. § 4-9-502)\***

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. The assignee of accounts, chattel paper, or instruments holds as collateral property which is not only the most liquid asset of the debtor's business but also property which may be collected without any interruption of the business, assuming it to continue after default. The situation is far different from that where the collateral is inventory or equipment, whose removal may bring the business to a halt. Furthermore the problems of valuation and identification, present where

the collateral is tangible chattels, do not arise so sharply on the assignment of intangibles. Considerations, similar although not identical, apply to assignments of general intangibles, which are also covered by the rule of the section. Consequently, this section recognizes the fact that financing by assignment of intangibles lacks many of the complexities which arise after default in other types of financing, and allows the assignee to liquidate in the regular course of business by collecting whatever may become due on the collateral, whether or not the method of collection contemplated by the security

arrangement before default was direct (i.e., payment by the account debtor to the assignee, "notification" financing) or indirect (i.e., payment by the account debtor to the assignor, "non-notification" financing). By agreement, of course, the secured party may have the right to give notice and to make collections before default.

2. In one form of accounts receivable financing, which is found in the "factoring" arrangements which are common in the textile industry, the assignee assumes the credit risk — that is, he buys the account under an agreement which does not provide for recourse or charge-back against the assignor in the event the account proves uncollectible. Under such an arrangement, neither the debtor nor his creditors have any legitimate concern with the disposition which the assignee makes of the accounts. Under another form of accounts receivable financing, however, the assignee does not assume the credit risk and retains a right of full or limited recourse or charge-back for uncollectible accounts. In such a case both debtor and creditors have a right that the assignee not dump the accounts, if the result will be to increase a possible deficiency claim or to reduce a possible surplus.

3. Where an assignee has a right of charge-back or a right of recourse, subsection (2) (A.C.A. § 4-9-502(2)) provides that liquidation must be made with due regard to the interest of the assignor and of his other creditor — "in a commercially reasonable manner" (compare Section 9-504 (A.C.A. § 4-9-504) and see Section 9-507(2) (A.C.A. § 4-9-507(2))) — and the proceeds allocated to the expenses of realization and to the indebtedness. If the "charge-back" provisions of the assignment arrangement provide only for "charge-back" of bad accounts against a reserve, the debtor's claim to surplus and his liability for a deficiency are limited to the amount of the reserve.

4. Financing arrangements of the type dealt with by this section are between business men. The last sentence of subsection (2) (A.C.A. § 4-9-502(2)) therefore

preserves freedom of contract, and the subsection recognizes that there may be a true sale of accounts or chattel paper although recourse exists. The determination whether a particular assignment constitutes a sale or a transfer for security is left to the courts. Note that, under Section 9-102 (A.C.A. § 4-9-102), this Article (Chapter) applies both to sales and to security transfers of such intangibles.

#### *Cross References:*

Sections 9-205 (A.C.A. § 4-9-205) and 9-306 (A.C.A. § 4-9-306).

Point 3: Sections 9-504 (A.C.A. § 4-9-504) and 9-507(2) (A.C.A. § 4-9-507(2)).

Point 4: Sections 9-102(1)(b) (A.C.A. § 4-9-102(1)(b)) and 9-104(f) (A.C.A. § 4-9-104(f)).

#### *Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Account debtor". Section 9-105 (A.C.A. § 4-9-105).

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Instrument". Section 9-105 (A.C.A. § 4-9-105).

"Notify". Section 1-201 (A.C.A. § 4-1-201).

"Proceeds". Section 9-306 (A.C.A. § 4-9-306).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

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\*This section was amended by Acts 1967, No. 303, § 35, to insert the language that was omitted from the original enactment but found in the Uniform Commercial Code section, and by Acts 1973, No. 116, § 1, to incorporate the 1972 changes to this Uniform Commercial Code section.



**1972 Official Comment to § 9-503 (A.C.A. § 4-9-503)\***

*Prior Uniform Statutory Provision:* Section 6, Uniform Trust Receipts Act; Sections 16 and 17, Uniform Conditional Sales Act.

*Purposes:*

Under this Article (Chapter) the secured party's right to possession of the collateral (if he is not already in possession as pledgee) accrues on default unless otherwise agreed in the security agreement. This Article (Chapter) follows the provisions of the earlier uniform legislation in allowing the secured party in most cases to take possession without the issuance of judicial process. In the case of collateral such as heavy equipment, the physical removal from the debtor's plant and the storage of the equipment pending resale may be exceedingly expensive and in some cases impractical. The section therefore provides that in lieu of removal the lender may render equipment unusable or dispose of collateral on the debtor's premises. The authorization to render equipment unusable or to dispose of collateral without removal would not justify unreasonable action by the secured party, since, under Section 9-504(3) (A.C.A. § 4-

9-504(3)), all his actions in connection with disposition must be taken in a "commercially reasonable manner".

*Cross Reference:*

Section 9-504 (A.C.A. § 4-9-504).

*Definitional Cross References:*

"Action". Section 1-201 (A.C.A. § 4-1-201).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Equipment". Section 9-109 (A.C.A. § 4-9-109).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-503), to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-504 (A.C.A. § 4-9-504)\***

*Prior Uniform Statutory Provision:* Section 6, Uniform Trust Receipts Act; Sections 19, 20, 21, 22, Uniform Conditional Sales Act.

*Purposes:*

1. The Uniform Trust Receipts Act provides that an entruster in possession after default holds the collateral with the rights and duties of a pledgee, and, in particular, that he may sell such collateral at public or private sale with a right to claim deficiency and a duty to account for any surplus. The Uniform Conditional Sales Act insisted on a sale at public auction with elaborate provisions for the giving of notice of sale. This section follows the more liberal provisions of the Trust Receipts Act. Although public sale is recognized, it is hoped that private sale will be encouraged where, as is frequently the case, private sale through commercial channels will result in higher realization on collateral for the benefit of all parties.

The only restriction placed on the secured party's method of disposition is that it must be commercially reasonable. In this respect this section follows the provisions of the section on resale by a seller following a buyer's rejection of goods (Section 2-706 (A.C.A. § 4-2-706)). Subsection (1) (A.C.A. § 4-9-504(1)) does not restrict disposition to sale: the collateral may be sold, leased, or otherwise disposed of — subject of course to the general requirements of subsection (2) (A.C.A. § 4-9-504(2)) that all aspects of the disposition be "commercially reasonable". Section 9-507(2) (A.C.A. § 4-9-507(2)) states some tests as to what is "commercially reasonable".

2. Subsection (1) (A.C.A. § 4-9-504(1)) in general follows prior law in its provisions for the application of proceeds and for the debtor's right to surplus and liability for deficiency. Under paragraph (1)(c) (A.C.A. § 4-9-504(1)(c)) the secured party, after paying expenses of retaking and disposition and his own debt, is required

to pay over remaining proceeds to the extent necessary to satisfy the holder of any junior security interest in the same collateral if the holder of the junior interest has made a written demand and furnished on request reasonable proof of his interest: this provision is necessary in view of the fact that under subsection (4) (A.C.A. § 4-9-504(4)) the junior interest is discharged by the disposition. Since the requirement is conditioned on written demand, it should not result in undue burden on the secured party making the disposition. It should be noted also that under Section 9-112 (A.C.A. § 4-9-112) where the secured party knows that the collateral is owned by a person who is not the debtor, the owner of the collateral and not the debtor is entitled to any surplus.

3. In any security transaction the debtor (or the owner of the collateral if other than the debtor: see Section 9-112 (A.C.A. § 4-9-112)) is entitled to any surplus which results from realization on the collateral; the debtor will also, unless otherwise agreed, be liable for any deficiency. Subsection (2) (A.C.A. § 4-9-504(2)) so provides. Since this Article (Chapter) covers sales of certain intangibles as well as transfers for security, the subsection also provides that apart from agreement the right to surplus or liability for deficiency does not accrue where the transaction between debtor and secured party was a sale and not a security transaction.

4. Subsection (4) (A.C.A. § 4-9-504(4)) provides that a purchaser for value from a secured party after default takes free of any rights of the debtor and of the holders of junior security interests and liens, even though the secured party has not complied with the requirements of this Part or of any judicial proceedings. This subsection follows a similar provision in the Uniform Trust Receipts Act and in the section of this Act on resale by a seller (Section 2-706 (A.C.A. § 4-2-706)). Where the purchaser for value has bought at a public sale he is protected under paragraph (a) (A.C.A. § 4-9-504(4)(a)) if he has no knowledge of any defects in the sale and was not guilty of collusive practices. Where the purchaser for value has bought at a private sale he must, to receive the protection of paragraph (b) (A.C.A. § 4-9-504(4)(b)), qualify in all respects as a purchaser in good faith. Thus while the purchaser at a private sale is required to

proceed in the exercise of good faith, the purchaser at public sale is protected so long as he is not acting in bad faith, and is put under no duty to inquire into the circumstances of the sale.

5. Both the Uniform Trust Receipts Act and the Uniform Conditional Sales Act required a waiting period after repossession and before sale (five days in the Trust Receipts Act, ten days in the Conditional Sales Act). Under subsection (3) (A.C.A. § 4-9-504(3)), the secured party in most cases is required to give reasonable notification of disposition to the debtor unless the debtor has after default signed a statement renouncing or modifying his right to notification of sale.

The secured party must also (except for consumer goods) give notice to any other secured parties who have in writing given notice of a claim of an interest in the collateral. This latter notice must be given before the debtor renounces his rights or before the secured party gives his notification to the debtor. Compare Section 9-505(2) (A.C.A. § 4-9-505(2)). Except for the requirement of notification there is no statutory period during which the collateral must be held before disposition. "Reasonable notification" is not defined in this Article (Chapter); at a minimum it must be sent in such time that persons entitled to receive it will have sufficient time to take appropriate steps to protect their interests by taking part in the sale or other disposition if they so desire.

6. Section 19 of the Uniform Conditional Sales Act required that sale be made not more than thirty days after possession taken by the conditional vendor. The Uniform Trust Receipts Act contained no comparable provision. Here again this Article (Chapter) follows the Trust Receipts Act, and no period is set within which the disposition must be made, except in the case of consumer goods which under Section 9-505(1) (A.C.A. § 4-9-505(1)) must in certain instances be sold within ninety days after the secured party has taken possession. The failure to prescribe a statutory period during which disposition must be made is in line with the policy adopted in this Article (Chapter) to encourage disposition by private sale through regular commercial channels. It may, for example, be wise not to dispose of goods when the market has collapsed, or to sell a large inventory



in parcels over a period of time instead of in bulk. Note, however, that under subsection (3) (A.C.A. § 4-9-504(3)) every aspect of the sale or other disposition of the collateral must be commercially reasonable; this specifically includes method, manner, time, place and terms. See Section 9-507(2) (A.C.A. § 4-9-507(2)). Under that provision a secured party who without proceeding under Section 9-505(2) (A.C.A. § 4-9-505(2)) held collateral a long time without disposing of it, thus running up large storage charges against the debtor, where no reason existed for not making a prompt sale, might well be found not to have acted in a "commercially reasonable" manner. See also Section 1-203 (A.C.A. § 4-1-203) on the general obligation of good faith.

*Cross References:*

Point 1: Sections 2-706 (A.C.A. § 4-2-706) and 9-507(2) (A.C.A. § 4-9-507(2)).

Point 2: Section 9-112 (A.C.A. § 4-9-112).

Point 3: Sections 9-102(1)(b) (A.C.A. § 4-9-102(1)(b)) and 9-112 (A.C.A. § 4-9-112).

Point 4: Section 2-706 (A.C.A. § 4-2-706).

Point 6: Sections 9-505 (A.C.A. § 4-9-505) and 9-507(2) (A.C.A. § 4-9-507(2)).

*Definitional Cross References:*

"Account". Section 9-106 (A.C.A. § 4-9-106).

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Chattel paper". Section 9-105 (A.C.A. § 4-9-105).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Consumer goods". Section 9-109 (A.C.A. § 4-9-109).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Financing statement". Section 9-402 (A.C.A. § 4-9-402).

"Gives notification". Section 1-201 (A.C.A. § 4-1-201).

"Good faith". Section 1-201 (A.C.A. § 4-1-201).

"Goods". Section 9-105 (A.C.A. § 4-9-105).

"Knowledge". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Proceeds". Section 9-306 (A.C.A. § 4-9-306).

"Purchaser". Section 1-201 (A.C.A. § 4-1-201).

"Receives notification". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Sale". Sections 2-106 (A.C.A. § 4-2-106) and 9-105 (A.C.A. § 4-9-105).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security agreement". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Term". Section 1-201 (A.C.A. § 4-1-201).

"Value". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-504), to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-505 (A.C.A. § 4-9-505)\***

*Prior Uniform Statutory Provision:* Section 23, Uniform Conditional Sales Act.

*Purposes:*

1. Experience has shown that the parties are frequently better off without a resale of the collateral; hence this section sanctions an alternative arrangement. In lieu of resale or other disposition, the secured party may propose under subsection

(2) (A.C.A. § 4-9-505(2)) that he keep the collateral as his own, thus discharging the obligation and abandoning any claim for a deficiency. This right may not be exercised in the case of consumer goods where the debtor has paid 60% of the price or obligation and thus has a substantial equity, and may be exercised in other cases only on notification to the debtor,

unless the debtor has signed after default a statement renouncing or modifying his rights under this section, and (except in the case of consumer goods) to any other secured party who has given written notice of a claim of an interest in the collateral. In the latter case, notice must be given before the secured party receives the debtor's renunciation or before he sends his notice to the debtor. The secured party may keep the goods in lieu of sale on failure of anyone receiving notification to object within twenty-one days.

2. When an objection is received by the secured party he must then proceed to dispose of the collateral in accordance with Section 9-504 (A.C.A. § 4-9-504), and on failure to do so would incur the liabilities set out in Section 9-507 (A.C.A. § 4-9-507). In the case of consumer goods where 60% of the price or obligation has been paid the disposition must be made within 90 days after possession taken. For failure to make the sale within the 90-day period the secured party is liable in conversion or alternatively may incur the liabilities set out in Section 9-507 (A.C.A. § 4-9-507).

In the absence of objection the secured party is bound by his notice.

3. After default (but not before) a consumer-debtor who has paid 60% of the case price may sign a written renunciation of his rights to require resale of the collateral.

*Cross References:*

Sections 9-504 (A.C.A. § 4-9-504) and

9-507(1) (A.C.A. § 4-9-507(1)).

*Definitional Cross References:*

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Consumer goods". Section 9-109 (A.C.A. § 4-9-109).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Knows". Section 1-201 (A.C.A. § 4-1-201).

"Notice". Section 1-201 (A.C.A. § 4-1-201).

"Person". Section 1-201 (A.C.A. § 4-1-201).

"Purchase money security interest". Section 9-107 (A.C.A. § 4-9-107).

"Receives notification". Section 1-201 (A.C.A. § 4-1-201).

"Rights". Section 1-201 (A.C.A. § 4-1-201).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Security interest". Section 1-201 (A.C.A. § 4-1-201).

"Send". Section 1-201 (A.C.A. § 4-1-201).

"Signed". Section 1-201 (A.C.A. § 4-1-201).

"Written". Section 1-201 (A.C.A. § 4-1-201).

\*This section was amended by Acts 1973, No. 116, § 1 (9-505), to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-506 (A.C.A. § 4-9-506)\***

*Prior Uniform Statutory Provision:* Section 18, Uniform Conditional Sales Act.

*Purposes:*

Except in the case stated in Section 9-505(1) (A.C.A. § 4-9-505(1)) (consumer goods) the secured party is not required to dispose of collateral within any stated period of time. Under this section so long as the secured party has not disposed of collateral in his possession or contracted for its disposition, and so long as his right to retain it has not become fixed under Section 9-505(2) (A.C.A. § 4-9-505(2)), the debtor or another secured party may redeem. The debtor must tender fulfillment of all obligations secured, plus certain expenses: if the agreement contains a

clause accelerating the entire balance due on default in one installment, the entire balance would have to be tendered. "Tendering fulfillment" obviously means more than a new promise to perform the existing promise; it requires payment in full of all monetary obligations then due and performance in full of all other obligations then matured. If unmatured obligations remain, the security interest continues to secure them as if there had been no default.

Under Section 9-504 (A.C.A. § 4-9-504) the secured party may make successive sales of parts of the collateral in his possession. The fact that he may have sold or contracted to sell part of the collateral would not affect the debtor's right under



this section to redeem what was left. In such a case, of course, in calculating the amount required to be tendered the debtor would receive credit for net proceeds of the collateral sold.

*Cross References:*

Sections 9-504 (A.C.A. § 4-9-504) and 9-505 (A.C.A. § 4-9-505).

*Definitional Cross References:*

"Agreement". Section 1-201 (A.C.A. § 4-1-201).

"Collateral". Section 9-105 (A.C.A. § 4-9-105).

"Contract". Section 1-201 (A.C.A. § 4-1-201).

"Debtor". Section 9-105 (A.C.A. § 4-9-105).

"Secured party". Section 9-105 (A.C.A. § 4-9-105).

"Writing". Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-506), to incorporate the 1972 changes to this Uniform Commercial Code section.

**1972 Official Comment to § 9-507 (A.C.A. § 4-9-507)\***

*Prior Uniform Statutory Provision:* None.

*Purposes:*

1. The principal limitation on the secured party's right to dispose of collateral is the requirement that he proceed in good faith (Section 1-203 (A.C.A. § 4-1-203)) and in a commercially reasonable manner. See Section 9-504 (A.C.A. § 4-9-504). In the case where he proceeds, or is about to proceed, in a contrary manner, it is vital both to the debtor and other creditors to provide a remedy for the failure to comply with the statutory duty. This remedy will be of particular importance when it is applied prospectively before the unreasonable disposition has been concluded. This section therefore provides that a secured party proposing to dispose of collateral in an unreasonable manner, may, by court order, be restrained from doing so, and such an order might appropriately provide either that he proceed with the sale or other disposition under specified terms and conditions, or that the sale be made by a representative of creditors where insolvency proceedings have been instituted. The section further provides for damages where the unreasonable disposition has been concluded, and, in the case of consumer goods, states a minimum recovery.

A case may be put in which the liquidation value of an insolvent estate would be enhanced by disposing of all the debtor's property (including that subject to a security interest) in the liquidation proceeding and in which, if a secured party repossesses and sells that part of the property which he holds as collateral, the remain-

der will have little or no resale value. In such a case the question may arise whether a particular court has the power to control the manner of disposition, although reasonable in other respects, in order to preserve the estate for the benefit of creditors. Such a power is no doubt inherent in a Federal bankruptcy court, and perhaps also in other courts of equity administering insolvent estates. Traditionally it was not exercised where the secured party claimed under a title retention device, such as conditional sale or trust receipt. See *In re Lake's Laundry, Inc.*, 79 F.2d 326 (2d Cir. 1935) and the remarks of Clark, J., concurring, in *In re White Plains Ice Service, Inc.*, 109 F.2d 913 (2d Cir. 1940). It has been held that distinctions in results based on these distinctions in form have been made obsolete by this Article (Chapter). In *re Yale Express System, Inc.*, 370 F.2d 433 (2d Cir. 1966), 384 F.2d 990 (2d Cir. 1967).

2. In view of the remedies provided the debtor and other creditors in subsection (1) (A.C.A. § 4-9-507(1)) when a secured party does not dispose of collateral in a commercially reasonable manner, it is of great importance to make clear what types of disposition are to be considered commercially reasonable, and in an appropriate case to give the secured party means of getting, by court order or negotiation with a creditors' committee or a representative of creditors, approval of a proposed method of disposition as a commercially reasonable one. Subsection (2) (A.C.A. § 4-9-507(2)) states rules to assist in the determination, and provides for such advance approval in appropriate sit-

uations. One recognized method of disposing of repossessed collateral is for the secured party to sell the collateral to or through a dealer — a method which in the long run may realize better average returns since the secured party does not usually maintain his own facilities for making such sales. Such a method of sale, fairly conducted, is recognized as commercially reasonable under the second sentence of subsection (2) (A.C.A. § 4-9-507(2)). However, none of the specific methods of disposition set forth in subsection (2) (A.C.A. § 4-9-507(2)) is to be regarded as either required or exclusive, provided only that the disposition made or about to be made by the secured party is commercially reasonable.

*Cross References:*

Point 1: Sections 1-203 (A.C.A. § 4-1-203), 9-202 (A.C.A. § 4-9-202) and 9-504 (A.C.A. § 4-9-504).

*Definitional Cross References:*

“Collateral”. Section 9-105 (A.C.A. § 4-9-105).

“Consumer goods”. Section 9-109 (A.C.A. § 4-9-109).

“Creditor”. Section 1-201 (A.C.A. § 4-1-201).

“Debtor”. Section 9-105 (A.C.A. § 4-9-105).

“Knows”. Section 1-201 (A.C.A. § 4-1-201).

“Notification”. Section 1-201 (A.C.A. § 4-1-201).

“Person”. Section 1-201 (A.C.A. § 4-1-201).

“Representative”. Section 1-201 (A.C.A. § 4-1-201).

“Rights”. Section 1-201 (A.C.A. § 4-1-201).

“Secured party”. Section 9-105 (A.C.A. § 4-9-105).

“Security interest”. Section 1-201 (A.C.A. § 4-1-201).

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\*This section was amended by Acts 1973, No. 116, § 1 (9-507), to incorporate the 1972 changes to this Uniform Commercial Code section.



**ARTICLE 10**  
**(A.C.A. § 4-10-101 ET SEQ.)**

**Official Comment to § 10-101 (A.C.A. § 4-10-101)**

This effective date is suggested so that there may be ample time for all those who will be affected by the provisions of the Code to become familiar with them.

**Official Comment to § 10-102 (A.C.A. § 4-10-102)**

Subsection (1) (A.C.A. § 4-10-102(1)) provides for the repeal of present uniform and other acts superseded by this Act. Subsection (2) (A.C.A. § 4-10-102(4)) provides for the transition to the Code.

**Official Comment to § 10-103 (A.C.A. § 4-10-103)**

This section provides for the repeal of all other legislation inconsistent with this Act.

**Official Comment to § 10-104 (A.C.A. § 4-10-104)**

This section subordinates the Article (Chapter) of this Act on Documents of Title (Article 7 (Chapter 7)) to the more specialized regulations of particular classes of bailees under other legislation and international treaties. Particularly, the provisions of that Article (Chapter) are superseded by applicable inconsistent provisions regarding the obligation of carriers and the limitation of their liability found in federal legislation dealing with transportation by water (including the Harter Act, Act of February 13, 1893, 27 Stat. 445, and the Carriage of Goods by Sea Act, Act of April 16, 1936, 49 Stat. 1207); the Warsaw Convention on International Air Transportation, 49 Stat. 3000, and Section 20(11) of the Interstate Commerce Act, Act of February 20, 1887, 24 Stat. 386, as amended. The Documents of Title provisions of this Act supplement

such legislation largely in matters other than obligation of the bailee, e.g., form and effects of negotiation, procedure in the case of lost documents, effect of over-issue, possibility of rapid transmission.

Doubts have been expressed whether Article 8 (Chapter 8) provides as complete protection on transfers of securities by fiduciaries as the Uniform Act for the Simplification of Fiduciary Security Transfers. The Editorial Board entirely favors the policy of simplifying fiduciary security transfers and believes that Article 8 (Chapter 8) soundly implements this policy. However, since the shorter Simplification Act has been so widely enacted and has been working satisfactorily, the Editorial Board recommends that it be retained.

*Cross Reference:*

Section 7-103 (A.C.A. § 4-7-103).

## BUSINESS CORPORATION ACT OF 1987

### (§ 4-27-101 ET SEQ.)

**A.C.R.C. Notes.** The following notes are in addition to the official commentaries to the Model Business Corporation Act. Except for the notes prepared by the Arkansas Code Revision Commission, these notes and the attendant commentaries to the Arkansas Business Corporation Act were presented to the Arkansas General Assembly by the sponsors of the Arkansas

Business Corporation Act along with the act. Unless otherwise noted, these notes were made by the sponsors of the Arkansas Business Corporation Act. For a copy of the official commentary and the model act, write to Prentiss Hall Law Publishers, Division of Services, #1 Gulf and Western Plaza, New York, New York 10023.

#### Comment to § 4-27-101

This Act, entitled the Arkansas Business Corporation Act, is based primarily upon the Revised Model Business Corporation Act (1984) (hereinafter referred to as the "Model Act"), adopted by the Committee on Corporate Laws of the Section of Corporation, Banking & Business Law of the American Bar Association.

Although they do not constitute a part of this Act, the Official Comments to each

section describe the substantive decisions made in the drafting of the section and explain the meaning and purpose of the section. The Official Comments also identify and describe any deviations between this Act and the Model Act. Statutory cross-references have been added after each section to enable the reader to identify and locate other relevant statutory provisions.

#### Comment to § 4-27-126

##### 1. *The Court with Jurisdiction to Hear Appeals from the Secretary of State.*

Jurisdiction to hear appeals from the Secretary of State under section 1.26 (A.C.A. § 4-27-126) has been placed in the Pulaski County Circuit Court. Other sections of this Act also designate the court with jurisdiction over substantive corporate matters. See, for example, section 7.03 (A.C.A. § 4-27-703), relating to the ordering of a shareholders' meeting after the corporation fails to hold such a meeting. It is expected that jurisdiction over litigation with respect to substantive matters will normally be vested in the court in the county of the corporation's principal or registered office. See the Official Comment to section 7.03 (A.C.A. § 4-27-703).

##### 2. *Orders.*

In view of the limited discretion of the Secretary of State under this Act, a "sum-

mary" order appears to be appropriate in section 1.26 (A.C.A. § 4-27-126). Throughout this Act the term "summarily order" or similar language is used where courts are authorized to order action taken and the person charged with taking the original action has little or no discretion. The word "summary" is not used in a technical sense but to refer to a class of cases where the court might appropriately order that action be taken on the face of the pleadings or after an oral hearing but without any need to resolve disputed factual issues.

##### 3. *Burden of Proof and Review Standard.*

This Act does not address either the burden of proof or the standard for review in judicial proceedings challenging action of the Secretary of State. It is contemplated that these matters will be governed by general principles of judicial review of agency action adopted in Arkansas.



## Comment to § 4-27-202\*

1. *Introduction.* (second paragraph)

No reference is made in section 2.02(A) (A.C.A. § 4-27-202(A)) either to the period of duration of the corporation or to its purpose. A corporation formed under these provisions will automatically have perpetual duration under section 3.02 (A.C.A. § 4-27-302) unless a special provision is included providing a shorter period. Subdivision 2.02(A)(5) (A.C.A. § 4-27-202(A)(5)) is a change from the model act, providing that the articles of incorporation must set forth a primary purpose or purposes for which the corporation is organized and which shall be given to the Secretary of State for informational purposes. Unless specifically stated in the articles of incorporation, the primary purpose(s) set forth in compliance with section 2.02(A)(5) (A.C.A. § 4-27-202(A)(5)) shall not limit the broad purposes provided in section 3.01 (A.C.A. § 4-27-301). The option of providing a narrower purpose clause is also preserved in sections 2.02(B)(2) (A.C.A. § 4-27-202(B)(2)) and 3.01 (A.C.A. § 4-27-301), with the effect described in the Official Comment to section 3.01 (A.C.A. § 4-27-301).

2. *Requirements.*

The only information required in the articles of incorporation to form a "standard" corporation is:

(1) The name, which must meet the requirements of chapter 4 of this Act.

(2) The number of shares the corporation is authorized to issue and whether such shares have a par value. This Act deviates from the Model Act by requiring the articles of incorporation to specify whether shares have a par value, and, if so, the par value of such shares. If a single class of shares is authorized, therefore, the articles of incorporation must disclose the number of shares authorized and the par value of those shares, or a statement that the shares have no par value. If more than one class of shares is authorized, the articles must contain not only the foregoing information for each class, but must also contain a description of the rights of each class. See the Official Comment to Section 6.01 (A.C.A. § 4-27-601) and 6.02 (A.C.A. § 4-27-602). It is unnecessary to

specify expected minimum capitalization, or contemplated issue price.

(3) The street address of the corporation's initial registered office and the name of its initial registered agent. A mailing address consisting only of a post office box is not sufficient.

(4) The name and address of each incorporator.

No reference need be made in these "standard" articles to a variety of other matters that are referred to in the statutes of any states. For example, there is no need to refer to preemptive rights. See section 6.30 (A.C.A. § 4-27-630) and the Official Comment. Generally, no substantive effect should be given to the absence of a specific reference to such matters in section 2.02 (A.C.A. § 4-27-202) since they are referred to in other sections of this Act, which usually provide an "opt in" privilege that permits a draftsman to elect special treatment if he so desires. See particularly the list of option provisions set forth in parts 4 and 5 of this Comment.

d. *Par value.*

This section departs from the Model Act in that par value is a mandatory statutory concept. Shares having a par value may not be issued for consideration less than the par value of such shares. See section 6.21(C) (A.C.A. § 4-27-621(C)).

g. *Limitation of Director Liability.*

Section 2.02(B)(3) (A.C.A. § 4-27-202(B)(3)) represents a deviation from the Model Act and is designed to conform to recent changes to the Delaware Business Corporation Act.

Section 2.02(B)(3) (A.C.A. § 4-27-202(B)(3)) represents a legislative response to recent changes in the market for directors' liability insurance. Such insurance has become a relatively standard condition of employment for directors. Recent changes in that market, including the unavailability of the traditional policies (and, in many cases, the unavailability of any type of policy from the traditional insurance carriers) have threatened the quality and stability of the governance of corporations because directors have become unwilling, in many instances, to serve without the protection which such

insurance provides and, in other instances, may be deterred by the unavailability of insurance from making entrepreneurial decisions. The provisions are intended to allow Arkansas corporations to provide substitute protection, in various forms, to their directors and to limit director liability under certain circumstances.

This provision enables a corporation in its original certificate of incorporation or an amendment thereto validly approved by stockholders to eliminate or limit personal liability of members of its board of directors or governing body for violations of a director's fiduciary duty of care. However, the amendment makes clear that no such provision shall eliminate or limit the liability of a director for breaching his duty of loyalty, failing to act in good faith, engaging in intentional misconduct or knowingly violating law, paying a dividend or approving a stock repurchase

which was illegal under this Act, or obtaining an improper personal benefit. This provision would have no effect on the availability of equitable remedies, such as an injunction or rescission, for breach of fiduciary duty.

(3) Other provisions not referred to in this Act that the draftsman decides should be included in the articles of incorporation. This includes but is not limited to any provision that this Act requires or permits to be set forth in the bylaws. See Section 2.02(B)(3) (A.C.A. § 4-27-202(B)(3)).

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\*The second paragraph of part 1 of the commentary to § 2.02 (A.C.A. § 4-27-202) was written by the Arkansas Code Revision Commission rather than by the drafters of the Arkansas Business Corporation Act.

#### **Comment to § 4-27-301\***

(Additional paragraph placed second)

Subsection 3.01(A) (A.C.A. § 4-27-301(A)) is a change from the model act in that a more limited purpose must specifically be set forth in the articles of incorporation. The statement of primary purpose(s) required by § 2.02(A)(5) (A.C.A. § 4-27-202(A)(5)) is not a specific limitation of the broad purposes for which the corporation may be organized.

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\*The second paragraph of the comment to section 3.01 (A.C.A. § 4-27-301) was written by the Arkansas Code Revision Commission rather than by the drafters of the Arkansas Business Corporation Act.

#### **Comment to § 4-27-621**

Section 6.21(A) (A.C.A. § 4-27-621(A)) provides that the power granted to the board of directors by this section may be reserved to the shareholders by the articles of incorporation. No negative inference should be drawn from section 6.21(A) (A.C.A. § 4-27-621(A)) with respect to the efficacy of similar provisions under other sections of this Act.

The Model Act authorizes a corporation to issue shares in exchange for any property of benefit to the corporation, including promissory notes and contracts for future services. Subsection (B) (A.C.A. § 4-27-621(B)) of this section departs from the Model Act by providing that shares may be issued only for money paid, labor done, or property actually received,

and that a promissory note or a promise of future services is not valid consideration for the issuance of shares. This change was necessitated by the language of Article 12, Section 8 of the Arkansas Constitution.

The same constitutional provision has required the addition of section 6.21(C) (A.C.A. § 4-27-621(C)), which provides that, in the event a corporation issues par value shares, it must receive as consideration for each share an amount at least equal to par value. There is no comparable provision in the Model Act.

Before a corporation may issue shares, subsection (D) (A.C.A. § 4-27-621(D)) of this section requires the board of directors to determine that the consideration re-



ceived or to be received for the shares is adequate. Despite that requirement, there is still the possibility that the issuance of some shares for cash and other shares for past services or property, like the issuance of shares for an inadequate consideration, will dilute the interests of other shareholders. For example, persons acquiring shares for cash may be unfairly treated if optimistic values are placed on services or property being provided by other persons. The problem is particularly acute if the persons providing services or property of debatable value are themselves connected with the promoters of the corporation or with its directors. Protection of shareholders against abuse of the power granted to the board of directors is provided in part by the requirement that the board must act in accordance with the requirements of section 8.30 (A.C.A. § 4-27-830), and, if applicable, section 8.31 (A.C.A. § 4-27-831), in determining that the consideration received for shares is adequate.

Accounting principles are not specified in this Act, and the board of directors is not required by the statute to determine the "value" of noncash consideration received by the corporation (as was the case in earlier versions of this Act). In many instances, property received by the corporation will be of uncertain value; if the board of directors determines that the issuance of shares for the property is an appropriate transaction that protects the shareholders from dilution, that is sufficient under section 6.21 (A.C.A. § 4-27-621). The board of directors does not have to make an explicit "adequacy" determination by formal resolution; that determination may be inferred from a determination to authorize the issuance of shares for a specified consideration.

Section 6.21 (A.C.A. § 4-27-621) also does not require that the board of directors determine the value of the consideration to be entered on the books of the corporation, though the board of directors may do so if it wishes. Of course, a specific value must be placed on the consideration received for the shares for bookkeeping purposes, but bookkeeping details are not the statutory responsibility of the board of directors. The statute also does not require the board of directors to determine the corresponding entry on the right-hand side of the balance sheet under owner's

equity to be designated as "stated capital" or be allocated among "stated capital" and other surplus accounts. The corporation, however, may determine that the shareholders' equity accounts should be divided into these traditional categories if it wishes.

The second sentence of section 6.21(D) (A.C.A. § 4-27-621(D)) describes the effect of the determination by the board of directors that consideration is adequate for the issuance of shares. That determination, without more, is conclusive to the extent that adequacy is relevant to the question whether the shares are validly issued, fully paid, and nonassessable. Section 6.21(C) (A.C.A. § 4-27-621(C)) provides that shares are fully paid and nonassessable when the corporation receives the consideration for which the board of directors authorized their issuance. Whether shares are validly issued may depend on compliance with corporate procedural requirements, such as issuance within the amount authorized in the articles of incorporation or holding a directors' meeting upon proper notice and with a quorum present. This Act does not address the remedies that may be available for issuances that are subject to challenge. This somewhat more elaborate clause replaces the provision in earlier versions of this Act and many state statutes that the determination by the board of directors of consideration for the issuance of shares was "conclusive in the absence of fraud in the transaction."

This Act does not address the question whether validly issued shares may thereafter be cancelled on the grounds of fraud or bad faith if the shares are in the hands of the original shareholder or other persons who were aware of the circumstances under which they were issued when they acquired the shares. It also leaves to the Arkansas Uniform Commercial Code other questions relating to the rights of persons other than the person acquiring the shares from the corporation.

As mandated by Article 12, Section 8 of the Arkansas Constitution, subsection (F) (A.C.A. § 4-27-621(F)) of this section prohibits the issuance of shares until the corporation has received the full amount of the consideration for the shares. Subsection (F) (A.C.A. § 4-27-621(F)) differs from the corresponding provision of the Model Act, which allows a corporation to

issue shares and to place those shares in escrow or otherwise restrict the transfer

of the shares pending receipt of payment for the shares.

### Comment to § 4-27-622

Section 6.22(A) (A.C.A. § 4-27-622(A)) imposes greater potential liability on a purchaser of par value shares than the corresponding provision of the Model Act. Section 6.22 (A.C.A. § 4-27-622) of the Model Act limits a purchaser's liability to an amount equal to "the consideration for which the shares were authorized to be issued ... or specified in the subscription agreement." Under the Model Act, therefore, a purchaser of par value shares who had paid none of the consideration due for his shares would be liable for an amount less than par value if a subscription agreement had provided for a price less than par value or the shares were authorized to be issued for an amount less than par value. Section 6.22(A) (A.C.A. § 4-27-622(A)), on the other hand, limits the same purchaser's liability to the "full consideration, fixed as provided by law, for which the shares were issued or were to be issued." Since the full consideration provided by law for par value shares is par value, see section 6.21(C) (A.C.A. § 4-27-621(C)), the purchaser is liable for that amount. Section 6.22(A) (A.C.A. § 4-27-622(A)) was drafted to conform with Article 12, Section 8 of the Arkansas Constitution.

With regard to purchasers of shares

without par value, section 6.22(A) (A.C.A. § 4-27-622(A)) imposes the same potential liability as the Model Act: the difference between the amount of consideration the purchaser agreed to pay and the amount he actually did pay.

Section 6.22(A) (A.C.A. § 4-27-622(A)) deals only with the responsibility for payment by the purchaser of shares from the corporation. This Act leaves to the ARKANSAS UNIFORM COMMERCIAL CODE questions with respect to the rights of subsequent purchasers of shares and the power of the corporation to cancel shares if the consideration is not paid when due. See sections 8-202 (A.C.A. § 4-8-202) and 8-301 (A.C.A. § 4-8-301) of the ARKANSAS UNIFORM COMMERCIAL CODE.

Section 6.22(B) (A.C.A. § 4-27-622(B)) sets forth the basic rule of nonliability of shareholders for corporate acts or debts that underlies modern corporation law. Unless such liability is provided for in the articles of incorporation, see section 2.03(B)(3)(v) (A.C.A. § 4-27-203(B)(3)(v)), shareholders are not liable for corporate obligations, though the last clause recognizes that such liability may be assumed voluntarily or by other conduct.

### Comment to § 4-27-625

This section sets forth the minimum requirements for share certificates. A corporation whose shares are not publicly traded will normally issue certificates that meet these minimum requirements and little more. Securities that are publicly traded, on the other hand, must contain reasonable safeguards against fraudulent duplication; for this reason, regulations by exchanges contain technical requirements relating to design, workmanship, engraving, and printing. Also, exchange requirements may require signatures of a transfer agent and registrar as well as designated corporate officers. All these requirements are in addition to the minimum requirements of this Act.

Certificateless shares are permitted un-

der section 6.25(A) (A.C.A. § 4-27-625(A)) upon compliance with section 6.26 (A.C.A. § 4-27-626). Section 6.25(A) (A.C.A. § 4-27-625(A)) makes it clear that there are no differences in the rights and obligations of shareholders, whether or not their shares are represented by certificates, other than mechanical differences, such as the means by which instructions for transfer are communicated to the issuer, necessitated by the use or nonuse of certificates. If share transfer restrictions are imposed, conspicuous references must appear on the certificate if they are to be binding on third persons without knowledge of the restrictions. See section 6.27 (A.C.A. § 4-27-627).

Under section 6.25 (A.C.A. § 4-27-625)



all signatures on a share certificate may be facsimiles. This change, which has been adopted recently in several states, gives recognition to the fact that a purchaser of publicly traded shares will hardly ever be in a position to determine whether a manual signature on a stock certificate is in fact the authorized signature of an officer or the transfer agent or registrar. From the standpoint of the issuing corporation of publicly traded securities, if a share certificate requiring a manual signature is stolen and the signature thereafter forged, the corporation may defend on lack of genuineness under section

8-202(3) (A.C.A. § 4-8-202(3)) of the Arkansas Uniform Commercial Code. But this defense is not effective against a bona fide purchaser when the forged signature has been placed on the certificate by an employee of the issuer or registrar or transfer agent entrusted with handling the certificates (UCC § 8-205 (A.C.A. § 4-8-205)). It is likely that a corporation would therefore follow the same security precautions for blank certificates requiring manual signatures as for those not requiring them. At the same time, the time and expense required for manual signatures has been eliminated.

### Comment to § 4-27-704

The first sentence of section 7.04(A) (A.C.A. § 4-27-704(A)) provides that all the shareholders of a corporation may validly act by unanimous written consent without a meeting on proposals to increase the capital stock or bond indebtedness of the corporation. It is intended to comply with Article 12, Section 8 of the Arkansas Constitution, which contains special notice and voting requirements relating to such matter. Unanimous written consent is obtainable, as a practical matter, only on matters on which there are relatively few shareholders entitled to vote.

The second sentence of section 7.04(A) (A.C.A. § 4-27-704(A)) is based on the fundamental premise that if the holders of shares having the minimum number of votes that would be necessary to authorize a corporate action desire that action to be taken, no purpose is served by requiring the formality of holding a meeting of shareholders. Action by written consent has the same effect as a meeting vote and may be described as such in any document, including documents delivered to the Secretary of State for filing. Section 7.04 (A.C.A. § 4-27-704) is applicable to any shareholder action, including, without limitation, election of directors, approval of mergers or sales of substantially all the corporate property not in the ordinary course of business, amendments of articles of incorporation, and dissolution.

#### 1. *Form of Written Consent.*

To be effective, consents must be in writing, signed by the required number of

shareholders and delivered to the secretary of the corporation. The phrase "one or more written consents" is included in section 7.04(A) (A.C.A. § 4-27-704(A)) to make it clear that all shareholders do not need to sign the same piece of paper. The record date for determining who is entitled to vote, if not otherwise fixed by or in accordance with the bylaws, is the date the first shareholder signs the consent.

#### 2. *Revocation of Consent.*

Action by written consent is effective only when the required number of shareholders have signed the appropriate written consent and all consents have been delivered to the secretary of the corporation. Before that time any shareholder may withdraw his consent simply by advising the secretary of the fact. Cf. *Calumet Industries, Inc. v. McClure*, 464 F. Supp. 19 (N.D. Ill. 1978). The withdrawal of a single consent, of course, destroys the unanimous written consent required by the first sentence of subsection (A) (A.C.A. § 4-27-704(A)). If a shareholder seeks to withdraw his consent after all shareholders have signed written consents and filed them with the secretary of the corporation, the corporation may treat the attempted withdrawal as too late or give it effect, thereby requiring the matter to be presented at a shareholders' meeting.

#### 3. *Consent to Fundamental Corporate Changes.*

Section 7.04 (A.C.A. § 4-27-704) is applicable to all shareholder actions, including the approval of fundamental corporate

changes described in §§ 10.01 et seq. (A.C.A. § 4-27-1001 et seq.); 11.01 et seq. (A.C.A. § 4-27-1101 et seq.); 12.01 et seq. (A.C.A. § 4-27-1201 et seq.); and 14.01 et seq. (A.C.A. § 4-27-1401 et seq.). If these actions were taken at an annual or special meeting, shareholders who were not entitled to vote on the matter would nevertheless be entitled to receive notice of the meeting, including a description of the transaction proposed to be considered at the meeting. See, e.g., sections 10.03

(A.C.A. § 4-27-1003) (notice of proposed amendment), 11.03 (A.C.A. § 4-27-1103) (notice of proposed merger). In order to ensure that nonvoting shareholders have essentially the same right if action is taken by consent rather than at a meeting, section 7.04(D) (A.C.A. § 4-27-704(D)) provides that all nonvoting shareholders must be given at least 10 days written notice of the fundamental corporate changes that are proposed for approval by consent.

### Comment to § 4-27-705\*

#### 2. Discretion as to Calls of Special Meeting.

Under section 7.02(A)(2) (A.C.A. § 4-27-702(A)(2)) it is possible that more than one faction of shareholders may demand meetings at roughly the same time or that a single (or changing) faction of shareholders may request consecutive, overlapping, or repetitive meetings. The responsible corporate officers have some discretion as to the call and purposes of a meeting, and where demands are repetitious or overlapping, they may refuse to call a meeting for a purpose identical or similar to a purpose for which a previous special meeting was held in the recent past. Similarly, they may decline to call a special meeting when an annual meeting will be held in the near future. This limited discretion of the corporation to deny repetitive or overlapping demands may ultimately be tested under section 7.03 (A.C.A. § 4-27-703), which itself gives the court discretion whether or not to compel the holding of a special meeting under these circumstances. See the Official Comment to section 7.03 (A.C.A. § 4-27-703).

#### 3. Record Date.

Section 7.05(D) (A.C.A. § 4-27-705(D)) is a catch-all record date for both annual and special meetings. If the record date for notice and for voting entitlement is not otherwise fixed pursuant to section 7.03 (A.C.A. § 4-27-703) or 7.07 (A.C.A. § 4-27-707), the record date for purposes of determining who is entitled to notice and to vote at the meeting is the day before the first notice is delivered to shareholders. This provision differs from the Model Act, which provides that the record date for notice and voting entitlement will be the close of business on the day before notice is mailed unless another record date is fixed pursuant to § 7.03 (A.C.A. § 4-27-703) or § 7.07 (A.C.A. § 4-27-707).

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\*Part 3 of the comment to section 7.05 (A.C.A. § 4-27-705) was written by the Arkansas Code Revision Commission rather than by the drafters of the Arkansas Business Corporation Act.

### Comment to § 4-27-723

Traditionally, a corporation recognizes only the registered owner as the owner of shares. Indeed, section 1.40 (A.C.A. 4-27-140) defines "shareholder" basically as the registered owner of shares. But it has become a common practice for persons purchasing shares to have them registered in the "street name" of a broker-dealer or other financial institution, principally to facilitate transfer by eliminating the need for the beneficial owner's signature and delivery. In addition, in order to

avoid the burdens of processing securities transfers, which caused a crisis in the securities industry in the late 1960's, a system of securities depositories (defined as "clearing corporations" in section 1.02(3) (A.C.A. § 4-8-102(3)) of the Arkansas Uniform Commercial Code) has been developed. In this system, financial institutions deposit securities with the depository, which becomes the registered owner of the shares. Transfers between depositories are then accomplished by book entry



of the depository. As a result, there may be two entities interposed between the corporation and the beneficial owner with the depository being the registered owner for the account of the brokerage firm that in turn holds the shares for the account of the beneficial owner.

The purpose of section 7.23 (A.C.A. § 4-27-723) is to facilitate direct communication between the corporation and the beneficial owner by authorizing the corporation to create a procedure for bypassing both the registered owner and intermediate brokerage firms. The adoption of this procedure is discretionary with each corporation and affirmative action by the corporation is necessary to accomplish it. The procedure is also discretionary with the shareholder, who must elect to follow the applicable procedure prescribed by the corporation. The shareholder retains all of his rights except those granted to the beneficial owner.

The corporation may limit or qualify the procedure as it deems appropriate. For example, the corporation may:

1. limit the procedure to certain classes of shareholders, such as depositories, broker-dealers and banks, or their nominees, or make the procedure available to all shareholders;

2. permit a shareholder to adopt the procedure with respect to some but not all of the shares registered in his name (and in that case he continues to be treated as the shareholder with respect to the balance);

3. specify the purpose or purposes for which the certification is effective, e.g., for giving notice of, and voting at, shareholders' meetings, for the distribution of proxy statements and annual reports, or for payment of cash dividends;

4. specify the form of the certification, e.g., a written list, computer tape, or some other form of compatible input;

5. specify the type of information that must be provided, e.g., the name and address of the beneficial owner, his taxpayer identification number, and the number of shares registered directly in his name;

6. establish deadlines for receipt of the certifications after the establishment of a record date so that the corporation may schedule its mailings;

7. provide that a new certification is required following each record date or that a certification as of a certain date may continue until change by the certifying shareholder.

This listing is illustrative and not exhaustive. It is expected that experimentation with various devices under this section may reveal other areas which corporation's plan should address.

The definition of "shareholder" in section 1.40 (A.C.A. § 4-27-140) includes beneficial owners to the extent they obtain the rights of shareholders pursuant to the procedure authorized by this section.

### Comment to § 4-27-850

Section 8.50 (A.C.A. § 4-27-850) is taken verbatim from § 145 of the Delaware General Corporation Law. Under Section 8.50 (A.C.A. § 4-27-850), a director or officer of a corporation (i) shall be indemnified by the corporation for all expenses of litigation or other legal proceedings when he is successful on the merits, (ii) may be indemnified by the corporation for the expenses, judgments, fines and amounts paid in settlement of such litigation (other than a derivative suit) even if he is not successful on the merits if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation (and, in the case of a criminal proceeding, had no reason to believe his

conduct was not unlawful), and (iii) may be indemnified by the corporation for expenses of a derivative suit if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, provided that no such indemnification may be made in connection with derivative proceedings if the director or officer is adjudged liable to the corporation, unless a court determines that, despite such adjudication but in view of all of the circumstances, he is entitled to indemnification of such expenses. Indemnification provided for in subsections (A) and (B) of Section 8.50 (A.C.A. §§ 4-27-850(A) and 4-27-850(B)) shall be made only upon a determination by (i) a majority of a quorum of disinterested directors,

(ii) independent legal counsel or (iii) the shareholders, that indemnification is proper because the applicable standard of conduct is met.

Subsection (E) of Section 8.50 (A.C.A. § 4-27-850(E)) authorizes a corporation to pay the expenses incurred by an officer or director in a civil or criminal action in advance of the final disposition of the action. An advance for expenses pursuant to Subsection (E) (A.C.A. § 4-27-850(E)), however, is conditioned on the corporation's receipt of an undertaking by the director or officer to repay the advance in full in the event it is subsequently determined that the director or officer is not entitled to indemnification. Subsection (E) (A.C.A. § 4-27-850(E)), unlike the Model Act, does not require that a corporation's board of directors make a determination that the available facts would not preclude indemnification. Subsection (E) (A.C.A. § 4-27-850(E)), therefore, permits general authorization for advancement of expenses, including a mandatory provision in the corporation's articles of incorporation or bylaws to that effect.

Subsection (F) of Section 8.50 (A.C.A.

§ 4-27-850(F)) provides that an officer or director may have, in addition to the indemnification rights set forth in Section 8.50 (A.C.A. § 4-27-850), additional rights pursuant to any bylaw, agreement, vote of the corporation's stockholders or disinterested directors, or otherwise. This subsection differs from the comparable provision of the Model Act, which authorizes non-statutory indemnification rights only to the extent consistent with relevant statutory provisions.

Subsection (G) of Section 8.50 (A.C.A. § 4-27-850(G)) authorizes a corporation to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee, or agent of the corporation or served in such capacity at the request of the corporation for another entity. Section 8.50(G) (A.C.A. § 4-27-850(G)), like the comparable provision of the Model Act, authorizes the corporation to obtain such insurance "whether or not the corporation would have the power to indemnify" the director, officer, employee or agent pursuant to Section 8.50 (A.C.A. § 4-27-850).

#### **Comment to § 4-27-1431**

Section 14.31 (A.C.A. § 4-27-1431) designates the Attorney General as the officer to bring suits for involuntary dissolution by the State. The Pulaski County Circuit Court has been designated as the place of venue for proceedings brought by the Attorney General to dissolve a corporation. See the Official Comment to section 1.26

(A.C.A. § 4-27-126). Suits brought for judicial dissolution under other subdivisions of section 14.30 (A.C.A. § 4-27-1430) must be brought where the corporation's principal office is located or, if not located in this State, where its registered office is or was last located.

#### **Comment to § 4-27-1502\***

(Paragraph 4)

In addition to closing the courts of the state to a nonqualified foreign corporation, many states impose a penalty equal to all fees and franchise taxes that the foreign corporation would have been liable for if it had qualified to transact business when it was first required to do so. The Arkansas act differs from the Model Act in that it imposes a dollar amount as a civil penalty. The appropriate penalty will be calculated pursuant to regulations promulgated by the Secretary of State and will be determined by the size and assets

of the corporation, the total amount of business transacted within the state and such other circumstances as the Secretary of State determines to be appropriate. The penalty may be recovered by the Secretary of State in a proceeding instituted by him in the Pulaski County Circuit Court.

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\*The fourth paragraph of the commentary to § 15.02 (A.C.A. § 4-27-1502) was written by the Arkansas Code Revision Commission rather than by the drafters of the Arkansas Business Corporation Act.



**Comment to § 4-27-1602\***

5. A.C.A. § 4-27-1602(F).

A.C.A. § 4-27-1602(F) was added in the Arkansas act. This definition of shareholder does not appear in the model act.

(A.C.A. § 4-27-1602) was written by the Arkansas Code Revision Commission rather than by the drafters of the Arkansas Business Corporation Act.

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\*Part 5 of the commentary to § 16.02

**REVISED MODEL NONPROFIT CORPORATION ACT**  
(A.C.A. § 4-33-101 et seq.)

**INTRODUCTION**

**TO THE REVISED MODEL  
NONPROFIT CORPORATION  
ACT**

**BY**

**MICHAEL C. HONE\***

**BACKGROUND**

The Subcommittee on the Model Nonprofit Corporation Act ("Subcommittee") has completed a comprehensive revision of the Model Nonprofit Corporation Act ("Revised Act") (§ 4-33-101 et seq.). The process commenced in 1979 and ended in 1987. During this period the Subcommittee held 32 meetings and mailed over 1,000 exposure drafts to interested parties. A public comment period commenced in March of 1986. The Subcommittee reviewed all comments received through February 1987. Over 300 major and minor changes were made in the final version of the Revised Act (§ 4-33-101 et seq.) as a result of the suggestions received during the comment period.

A complete revision of the old Model Act ("Old Act"), promulgated in 1964, was needed because it did not address numerous questions, many of which have received increasing attention in recent years. For example, it did not set forth standards of care or loyalty for directors or officers. It did not deal with statutory immunity or protection for directors who acted with due care and did not breach their duty of loyalty. Nor did it provide conflict of interest rules. It did not deal with derivative suits, transfer and purchase of memberships, or the resignation or termination of members. It did not mention delegates or deal explicitly with self-perpetuating boards of directors or the delegation of authority by directors. It had not been amended to reflect the numerous changes that had occurred in state statutory and case law since its adoption.

Shortly after the project began the Committee on Corporate Laws decided to completely revise the Model Business Corporation Act ("MBCA") (§ 4-27-101 et seq.). The Subcommittee decided to track the MBCA (§ 4-27-101 et seq.) in form and substance whenever appropriate, particularly in regard to filings with the secretary of state, formation of corporations, corporate powers, qualification of foreign corporations, requirements for a corporate office and agent and procedures for merger and dissolution.

The Revised Act (§ 4-33-101 et seq.) follows the same organization and numbering system as the MBCA (§ 4-27-101 et seq.). Even where the substantive nonprofit provisions differ from the analogous business provisions they usually have the same section numbers as their business counterparts. This approach makes it easier for states which have adopted the MBCA (§ 4-27-101 et seq.) to adopt the Revised Act (§ 4-33-101 et seq.) because they will not have to review or work with an unfamiliar structure. A great debt is owed to the Committee on Corporate Laws and Robert Hamilton, the Reporter for the MBCA (§ 4-27-101 et seq.).

**The "Purpose" Debate**

The committee which drafted the Old Act did not agree on the nature of nonprofit corporations. The debate revolved around the question of the purposes for which nonprofit corporations could be formed. The Preface to the Old Act stated in part:

"The most difficult decision of policy

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\*Professor of Law at the University of San Francisco and Reporter for the Model Nonprofit Corporation Act.



in drafting the Model Non-Profit Corporation Act is the determination of the purposes for which corporations may be organized under it.”<sup>1</sup>

Section 4 of the Old Act provided that corporations could be organized “for any lawful purposes or purposes...” In addition it set forth nonexclusive examples of corporate purposes. The purposes included “charitable; benevolent, eleemosynary; educational; civic; patriotic; political; religious; social; fraternal; literary; cultural; athletic; scientific; agricultural; horticultural; animal husbandry; and professional, commercial, industrial or trade association...” The nonexclusive list of examples was intended to provide some guidance as to the nature of organizations which could be formed under the Old Act without falling into the trap of having an exclusive value-laden list of proper purposes. The list was so broad that almost any type of activity could come within its confines.<sup>2</sup>

Alternative section 4 allowed each state to list the purposes for which nonprofit corporations could not be formed. It did not provide a nonexclusive list of purposes.

The Subcommittee did not follow the approach of the Old Act. The Revised Act (§ 4-33-101 et seq.) does not set forth a nonexclusive list of proper purposes, nor does it contain a list of improper purposes. Instead section 3.01 of the Revised Act (§ 4-33-301) provides that “[e]very corporation incorporated under the Act has the purpose of engaging in any lawful activity unless a more limited purpose is set forth in the articles of incorporation.”<sup>3</sup>

### **Categories of Nonprofit Corporations**

Even though the Subcommittee did not follow the approach of the Old Act it was still faced with the perplexing question of whether there was any logical grouping of nonprofit corporations to which reason-

able statutory rules could be applied. In general the Old Act had applied one uniform set of rules to all nonprofit corporations. Statutes in New York<sup>4</sup> and California<sup>5</sup>, enacted after the Old Act, categorized nonprofit corporations and applied different rules to each category.

Nonprofit corporations engage in an almost endless variety of activities. Traditional nonprofit organizations operate as churches, charities, museums, schools and research organizations. Less traditional nonprofits operate as trade associations, political action committees, membership department stores, public interest law firms, consulting firms and television stations.

It is not helpful to categorize nonprofit corporations by using words alone, because words often have such broad or vague meanings as to be useless as guides or are so value-laden that they invite litigation. Relying on words alone invites lawyers to engage in unproductive characterization games.

The Subcommittee believed it could develop appropriate rules to apply to different categories of nonprofit corporations based upon the corporations' goals. The rules would apply whether or not the corporations met their goals. Logical rules could be developed for corporations implicitly or explicitly holding themselves out as:

1. Operating for public or charitable purposes - *public benefit corporations*;
2. Benefitting their members or a group of people they serve or represent - *mutual benefit corporations*; and
3. Operating primarily or exclusively for religious purposes - *religious corporations*.

No definitions of public, charitable or religious purposes are included in the Revised Act (§ 4-33-101 et seq.). Instead, those forming nonprofit corporations are

<sup>1</sup>Old Act, Preface to the 1964 edition, vii.

<sup>2</sup>Labor unions, cooperatives and organizations subject to state insurance laws were prohibited from incorporating under the Old Act.

<sup>3</sup>Cooperatives cannot be organized under the Revised Act (§ 4-33-101 et seq.). This is because nonprofit corporations are prohibited from making distributions and consequently cooperatives cannot pay patronage refunds. Labor unions may be formed as mutual benefit corporations under the Revised Act (§ 4-33-101 et seq.).

<sup>4</sup>New York Business Law Section 201.

<sup>5</sup>No California code section for this reference was provided to the publisher by the author of this Commentary.

allowed to choose the type of corporations they wish to organize. The choice is given because the Revised Act (§ 4-33-101 et seq.) contains rules and procedures appropriate to each of the three categories. The rules provide an incentive to choose the appropriate category and a disincentive to choose an inappropriate category.<sup>6</sup> The categories do not depend on self-interested characterizations or the "true" purpose of a corporation. The efficacy of the categories depends on applying appropriate rules and procedures to each category.

Incorporators may choose the category of nonprofit corporation they believe is most appropriate for the corporation's intended activities. In choosing a category, they should consider not only the corporation's intended activities, but the rules, regulations and procedures applicable to public benefit, mutual benefit and religious corporations. Once having chosen a category they are, however, required to abide by the rules applicable to that category.

When an incorporator has chosen to form a public benefit, mutual benefit or religious corporation, the secretary of state may not question the proposed corporations's intended activities, purposes or operations if the Revised Act's (§ 4-33-101 et seq.) filing requirements are met.<sup>7</sup> The secretary of state cannot challenge the corporation on the ground that it will not benefit the public or its members or that its purposes are not really religious.<sup>8</sup>

The revised Act (§ 4-33-101 et seq.) does not deal with the question of whether the activities of a public benefit corporation, or any other nonprofit corporation, can be so offensive to public policy that its existence can be challenged by the state in

a quo warranto or other proceeding. The matter is left to judicial development on a state by state basis.

Incorporators are not free to choose any category they desire. If incorporators want 501(c)(3) tax status under the Internal Revenue Code, they must form a public benefit or religious corporation.<sup>9</sup> It would be impossible for a public benefit or religious corporation to follow the Revised Act's (§ 4-33-101 et seq.) rules for mutual benefit corporations and obtain 501(c)(3) tax exempt status. This is because the rules applicable to mutual benefit corporations are inconsistent with the requirements of section 501(c)(3). While the Internal Revenue Code prohibits 501(c)(3) organizations from making distributions to their members the Revised Act (§ 4-33-101 et seq.) allows mutual benefit corporations to make such distributions upon dissolution.<sup>10</sup>

In many instances the distinctions between public benefit, mutual benefit and religious corporations do not require different rules and procedures. When there is no need for different rules, the Revised Act (§ 4-33-101 et seq.) applies the same rules to all three categories. In fact, for administrative ease and uniformity, many of these rules and procedures are the same as those applied by the MBCA to business corporations. (For example, there is no reason to have different rules in regard to forming corporations or having foreign corporations qualify for a certificate of authority to do business in a state.)

The following is a brief description of the Revised Act's (§ 4-33-101 et seq.) treatment of public benefit, mutual benefit and religious corporations.

<sup>6</sup>The rules and procedures are the most flexible and there is the least attorney general oversight over religious corporations. An individual might form and operate a corporation falsely representing it to be a religious corporation. The rules applicable to religious corporations mitigate against this choice as members, directors and officers are prohibited from having proprietary interests in religious corporations. Additionally, in appropriate cases, the status of a religious corporation can be challenged by the attorney general in a quo warranto or other proceeding.

<sup>7</sup>Section 1.25 (§ 4-33-125).

<sup>8</sup>In appropriate cases, a corporation may be challenged in a quo warranto proceeding.

<sup>9</sup>The provisions relating to public benefit corporations and religious corporations were sent to the Internal Revenue Service for comment. Changes were made in the Revised Act (§ 4-33-101 et seq.) to ensure that public benefit and religious corporations could qualify for tax exempt status.

<sup>10</sup>See section 14.06(a)(7) (§ 4-33-1406(a)(7)).



## PUBLIC BENEFIT, MUTUAL BENEFIT AND RELIGIOUS CORPORATIONS

### Public Benefit Corporations

Public benefit corporations hold themselves out as doing good works, benefitting society or improving the human condition. The Revised Act (§ 4-33-101 et seq.) therefore requires that they do not operate for the private economic benefit of their officers, directors, members or controlling persons.

Corporations which have 501(c) (3) status must be public benefit or religious corporations.<sup>11</sup> Other corporations may be public benefit corporations if they elect to be governed by rules appropriate to organizations holding themselves out as promoting the public good. For example, an environmental organization ineligible for tax exempt status because it intends to engage in extensive lobbying or endorse candidates could be formed as a public benefit corporation. Even if a corporation engages in controversial activities, it may be a public benefit corporation if its activities are lawful and it complies with the rules applicable to public benefit corporations.

One general rule is that members, unlike shareholders in business corporations, can have no ownership interest in their corporation. The assets of a public benefit corporation are held for public or charitable purposes and not to benefit members, directors, officers or controlling persons. The assets cannot be distributed to members, directors or officers either while the public benefit corporation is operating or upon its dissolution.<sup>12</sup> A

membership, unlike a security, cannot be sold or otherwise transferred by a member.<sup>13</sup> A public benefit corporation may not purchase any of its memberships or rights arising from its memberships.<sup>14</sup> Even if a member resigns or his or her membership is terminated, a public benefit corporation cannot make a payment to the member for such membership.<sup>15</sup>

Because members cannot have an economic interest in public benefit corporations, their right to vote on amendments to bylaws is not as broad as the right of members of mutual benefit corporations who can have a certain economic interest in mutual benefit corporations.<sup>16</sup>

To protect the assets held by public benefit corporations, the Revised Act (§ 4-33-101 et seq.) places restrictions on the type of corporations with which they can merge and the conditions of the merger.<sup>17</sup> The clearest sort of abuse would result if a public benefit corporation merged with a business corporation and the members of the public benefit corporation received stock or something else in exchange for their membership. The Revised Act (§ 4-33-101 et seq.) prohibits this from happening.<sup>18</sup>

Public benefit corporations hold themselves out as benefitting society. Donations to public benefit corporations are made with the expectation that the money will be used for the public good and not to benefit individual directors. Consequently, the Revised Act (§ 4-33-101 et seq.) holds directors of public benefit cor-

<sup>11</sup> See notes 9 and 10, *supra* and related text.

<sup>12</sup> Officers and directors can receive reasonable compensation. See Section 1.40(10) (§ 4-33-140(11)) (definition of "distribution") and the Official Comment to Section 1.40 (§ 4-33-140) (discussion of the term "distribution"); also see chapter 13 (§ 4-33-1301 et seq.) which deals with prohibited and authorized distributions. Bona fide corporate loans and debts may be paid to members, directors, officers and controlling persons. If members are 501(c) (3) organizations, they may receive a distribution upon dissolution of a public benefit or religious corporation. If the dissolving public benefit or religious corporation does not have 501(c) (3) tax status, distributions can be made to members who are public benefit or religious corporations. Section 14.06 (§ 4-33-1406).

<sup>13</sup> Section 6.11(b) (§ 4-33-611(b)).

<sup>14</sup> Section 6.22(a) (§ 4-33-622(a)).

<sup>15</sup> *Id.*

<sup>16</sup> See section 10.21 (§ 4-33-1021).

<sup>17</sup> Section 11.02 (§ 4-33-1102).

<sup>18</sup> Section 11.02 (§ 4-33-1102).

porations to a high standard when they engage in economic transactions with their corporations.<sup>19</sup> This will help ensure potential donors that their contributions will be dedicated to the corporation's public purposes and will not be used for private gain of the corporation's members or managers. The Revised Act (§ 4-33-101 et seq.) distinguishes between public benefit corporations and mutual benefit corporations. It applies the business standard to economic transactions between directors of mutual benefit corporations and their corporations,<sup>20</sup> but applies a more rigorous standard to the directors of public benefit corporations.<sup>21</sup>

Since members of public benefit corporations have no economic interest in their corporations, they have no personal economic incentive to monitor corporate activities and prevent abuses. Many public benefit corporations do not even have members. While contributors have an incentive to monitor corporate activities, they may have no practical means of doing so. Consequently there may be no private individual with an economic incentive to review decisions made by a public benefit corporation's directors.

The Revised Act (§ 4-33-101 et seq.) seeks to fill this void by statutorily clarifying existing common law and statutory authority of the attorney general.<sup>22</sup> It does this by authorizing the attorney general to monitor and exercise oversight powers over public benefit corporations.<sup>23</sup> The attorney general has authority to bring, must receive notice of, and may join in, derivative actions on behalf of public

benefit corporations.<sup>24</sup> The attorney general may approve conflict of interest transactions and must be made a party to proceedings in which a court is asked to approve conflict of interest transactions.<sup>25</sup> The attorney general may sue former or incumbent directors and officers for ultra vires acts, and may bring an action for breach of their duty of care or loyalty.<sup>26</sup> The attorney general may commence proceedings to hold an annual, regular or special meeting of members.<sup>27</sup>

The attorney general must be given notice of important corporate actions. Notices must be given in regard to: (1) indemnifying directors<sup>28</sup>; (2) merging<sup>29</sup>; (3) selling all or substantially all corporate assets<sup>30</sup>; (4) delivering articles of dissolution to the secretary of state<sup>31</sup>; and (5) transferring or conveying assets as part of the dissolution process.<sup>32</sup> In addition, the attorney general must be given notice after the assets have been transferred or conveyed following approval of dissolution.<sup>33</sup>

The standards, rules and procedures applicable to public benefit corporations are appropriate in light of the role they play in society and the representations they make to the public. Moreover, the rules prohibiting members from having an economic interest in public benefit corporations, providing scrutiny for director conflict of interest transactions and authorizing attorney general oversight mitigate against potential abuses by those operating public benefit corporations.

### **Mutual Benefit Corporations**

Trade associations, social clubs and fra-

<sup>19</sup> Section 8.31(b) (§ 4-33-831(b)).

<sup>20</sup> Section 8.31(c) (§ 4-33-831(c)).

<sup>21</sup> Section 8.31(b) (§ 4-33-831(b)).

<sup>22</sup> See Sections 1.70 and 6.30(f) (Sections 1.70 and 6.30 of the Revised Act were not enacted by Arkansas).

<sup>23</sup> *Id.*

<sup>24</sup> Section 6.30(b) (Section 6.30 was not enacted by Arkansas).

<sup>25</sup> Section 8.31(b) (2) (§ 4-33-831(b) (2)).

<sup>26</sup> Sections 1.70, 3.04(c) and 6.30(c) (Sections 1.70 and 6.30 were not enacted by Arkansas. Section 3.04(c) is codified as § 4-33-304(c)).

<sup>27</sup> Section 7.03(a) (§ 4-33-703(a)).

<sup>28</sup> Section 8.55(d) (§ 4-33-855(d)).

<sup>29</sup> Section 11.02(b) (Section 11.02(b) was not enacted by Arkansas).

<sup>30</sup> Section 12.02(b) (§ 4-33-1202(b)).

<sup>31</sup> Section 14.03(e) (Section 14.03 was not enacted by Arkansas).

<sup>32</sup> Section 14.03(b) (Section 14.03 was not enacted by Arkansas).

<sup>33</sup> Section 14.03(c) (Section 14.03 was not enacted by Arkansas).



ternal organizations are typical examples of mutual benefit corporations. Mutual benefit corporations hold themselves out as benefitting, representing and serving a group of individuals or entities. These individuals or entities are usually referred to as "members."<sup>34</sup>

Members may have an economic interest in mutual benefit corporations. Members may not receive distributions while a mutual benefit corporation is operating,<sup>35</sup> but their membership interests may be sold or transferred to the corporation or third parties,<sup>36</sup> and they may receive distributions when the corporation dissolves.<sup>37</sup>

Members have broad rights to vote on bylaw amendments to protect their economic and other interests.<sup>38</sup> If members do not approve of the manner in which their corporation is operating, they may elect new directors or take other action to protect their position as members. As the members form a countervailing force roughly equivalent to shareholders, there is little need to give the attorney general broad jurisdiction over the activities of mutual benefit corporations.

Mutual benefit corporations may operate with self-perpetuating boards of directors.<sup>39</sup> Individuals may be called "members" even if they do not have the right to vote for directors. As these "members" do not have the right to elect directors, the Revised Act (§ 4-33-101 et seq.) does not treat them as "members" and does not give them statutory rights.<sup>40</sup>

The Subcommittee rejected the idea of requiring all mutual benefit corporations to have members who could elect directors and therefore have statutory rights. Consequently some mutual benefit corpora-

tions may have individuals who are called members, but who do not have statutory membership rights under the Revised Act (§ 4-33-101 et seq.). The rights of these individuals is left to development on a state by state basis.

### **Religious Corporations**

A religious corporation is a corporation which: 1) is formed after the effective date of the Revised Act (§ 4-33-101 et seq.) and whose articles state that it is a religious corporation,<sup>41</sup> or 2) is in existence on the effective date of the Revised Act (§ 4-33-101 et seq.) and is designated by statute as a religious corporation or organized primarily or exclusively for religious purpose.<sup>42</sup> The Revised Act (§ 4-33-101 et seq.) does not define "religious purposes," but leaves this question for a determination on a case by case basis.

In general, the rules applicable to public benefit corporations are applicable to religious corporations. For example, members cannot have an economic interest in religious corporations and cannot receive distributions while they are operating or upon their dissolution.<sup>43</sup>

However, for sound constitutional and policy reasons the Revised Act (§ 4-33-101 et seq.) provides religious corporations with more flexibility in structure and operations than public benefit corporations. The constitutional limitations on state regulation of religious corporations are recognized by section 1.80 (§ 4-33-180).<sup>44</sup> Specific sections of the Revised Act (§ 4-33-101 et seq.) are not applicable to religious corporations. For example, the provisions relating to receiverships and custodianships<sup>45</sup> and to procedures on termination of members<sup>46</sup> are not applicable to religious corporations. Other sections of

<sup>34</sup> See discussion of members, pages xxii-xxiii *infra*.

<sup>35</sup> Section 13.01 (§ 4-33-1301).

<sup>36</sup> Section 13.02(a) (§ 4-33-1302(a)).

<sup>37</sup> Sections 13.02(b) and 14.06(a) (7) (§§ 4-33-1302(b) and 4-33-1406(a) (7)).

<sup>38</sup> Section 10.21 (§ 4-33-1021).

<sup>39</sup> Section 8.04(b) (§ 4-33-804(b)).

<sup>40</sup> See section 1.40(21) (§ 4-33-140(22)), the discussion on the term "member" in the official comment to Section 1.40 (§ 4-33-140) and pages xxxii-xxxiii *infra*.

<sup>41</sup> Section 2.02(a) (2) (§ 4-33-202(a) (2)).

<sup>42</sup> Section 17.07(1)&(2) (§ 4-33-1707(1) and (2)).

<sup>43</sup> See sections 6.11(b), 6.22(a), 13.01 (§§ 4-33-611(b), 4-33-622(a), and 4-33-1301).

<sup>44</sup> See the official comment to Section 1.80 (§ 4-33-180).

<sup>45</sup> Section 14.32 (§ 4-33-1432).

<sup>46</sup> Section 6.21 (§ 4-33-621).

the Revised Act (§ 4-33-101 et seq.) may be negated by the articles or bylaws of religious corporations. These sections include: (1) the provisions relating to the removal of directors elected by members or directors;<sup>47</sup> Section 8.08(j) (§ 4-33-808(j)), and (2) the right of members to inspect membership lists and receive financial statements.<sup>48</sup>

By applying fewer rules to religious corporations, allowing them greater flexibility and limiting the attorney general's jurisdiction, the Revised Act (§ 4-33-101 et seq.) recognizes the need to avoid unconstitutional intrusions into the activities of religious corporations and the desirability of allowing religious cor-

porations great flexibility in their structure and procedures.

While the attorney general has extensive oversight powers over public benefit corporations, the Revised Act (§ 4-33-101 et seq.) limits these powers over religious corporations. For example, the secretary of state in dissolving a public benefit corporation must give notice to the attorney general, but is not required to do so in regard to religious corporations.<sup>49</sup> Similarly, when public benefit corporations dissolve, they, but not religious corporations, must give the names and addresses of the individuals who received their assets to the attorney general.<sup>50</sup>

## IMPORTANT ASPECTS OF REVISED ACT (§ 4-33-101 et seq.)

### **1. The Revised Act (§ 4-33-101 et seq.) facilitates incorporating while requiring incorporators to decide basic questions as part of the incorporation process.**

The Revised Act (§ 4-33-101 et seq.) follows the same simplified incorporation procedure as the MBCA (§ 4-27-101 et seq.).<sup>51</sup> No attorney general or court approval is required.

Incorporators must answer the following three fundamental questions in filing articles of incorporation:

(i) Will the corporation be a public benefit, mutual benefit or religious corporation;<sup>52</sup>

(ii) Will the corporation have members;<sup>53</sup>

(iii) What provisions will be made for distribution of corporate assets upon dissolution.<sup>54</sup>

The Revised Act (§ 4-33-101 et seq.)

minimizes future disputes and confusion by requiring consideration of these questions as part of the incorporation process. Prior to the adoption of the Revised Act (§ 4-33-101 et seq.), the policy questions underlying these questions were often ignored when nonprofit corporations were formed. The significance of each of these matters is discussed elsewhere in this Introduction.

### **2. The Revised Act (§ 4-33-101 et seq.) requires incorporators to consider and evaluate the essence of their corporation when they choose between public benefit, mutual benefit and religious corporations.**

The articles of newly formed corporations must state whether they are public benefit, mutual benefit, or religious corporations.<sup>55</sup> See the discussion of public benefit, mutual benefit and religious corpora-

<sup>47</sup>Section 8.08(j) (§ 4-33-808(j)).

<sup>48</sup>Sections 16.02(e), 7.20(f) and 16.20(a) (Sections 16.02 and 16.20 were not enacted by Arkansas. Section 7.20(f) is codified as § 4-33-720(f)).

<sup>49</sup>Section 14.21(a) (§ 4-33-1421(a)).

<sup>50</sup>Section 14.03(c) (Section 14.03 was not enacted by Arkansas).

<sup>51</sup>Compare Chapter 2 of the Revised Act (§ 4-33-201 et seq.) with Chapter 2 of MBCA (§ 4-27-201 et seq.).

<sup>52</sup>Section 2.02(a) (2) (§ 4-33-202(a) (2)). See discussion of public benefit, material benefit and religious corporations pages xxiv-xxxi supra.

<sup>53</sup>Section 2.02(a) (5) (§ 4-33-202(a) (5)). See discussion of members xxxii-xxxiii infra.

<sup>54</sup>Section 2.02(a) (6) (§ 4-33-202(a) (6)). See discussion of dissolution page xxxiv infra.

<sup>55</sup>Section 2.02(a) (6) (§ 4-33-202(a) (6)).



tions for an explanation of the importance of these distinctions.<sup>56</sup>

**3. The Revised Act (§ 4-33-101 et seq.) facilitates choices between different organizational structures by clarifying the rights of members and authorizing delegates and self-perpetuating boards of directors.**

The Old Act defined the term "member" as "one having membership rights in a corporation in accordance with the provisions of its articles of incorporation or bylaws."<sup>57</sup> This approach leads to some uncertainty. Some courts have found that members have certain rights even though the rights were not contained in the corporate articles or bylaws.<sup>58</sup> In other cases courts have found that members' rights are solely dependent upon the rights set forth in the corporate articles and bylaws.<sup>59</sup>

The Revised Act (§ 4-33-101 et seq.) uses the term "member" in a narrow sense to refer to a person who on more than one occasion has the right pursuant to an article or bylaw provision to vote for a director or directors.<sup>60</sup> Simply calling a person a member does not give the person rights as a statutory member under the Revised Act (§ 4-33-101 et seq.).

A corporation does not have to have statutory members.<sup>61</sup> It may operate through a self-perpetuating board or through delegates.<sup>62</sup> If a corporation decides to have members, the Revised Act

(§ 4-33-101 et seq.) gives these members statutory rights.<sup>63</sup>

Those incorporating under the Revised Act (§ 4-33-101 et seq.) must state in the corporation's articles whether or not it will have statutory members.<sup>64</sup> This requires incorporators to consider alternative forms of organization and to make a choice in light of the rights statutory members would have and the appropriateness of having such members.

Public benefit corporations may or may not have statutory members, depending on the nature of their activities, the desire for a democratic structure, the cost of having members, concepts of efficiency, the need for member input and numerous other factors.

Almost all mutual benefit corporations have "members" for whose benefit they operate. In most cases, the people benefited will vote for directors and thus be "members" as that term is defined in the Revised Act (§ 4-33-101 et seq.).

Whether or not religious corporations have statutory members depends on the nature of the religion. In general, if a religious corporation is congregational, it will have statutory members. If it is hierarchical, it will not.

Some corporations hold conventions of delegates who meet and decide various organizational and policy matters. The Revised Act (§ 4-33-101 et seq.) authorizes delegates to have some or all of the

<sup>56</sup> Pages xxiv-xxxi *supra*.

<sup>57</sup> Section 2(f) of the Old Act.

<sup>58</sup> See *Valle v. North Jersey Automobile Club*, 125 N.J. Super 302, 310 A.2d 518 (1973).

<sup>59</sup> See *Orchard Ridge Country Club, Inc. v. Schrey*, 470 N.E.2d 780 (1984); *Harden v. Colonial Country Club*, 234 S.W.2d 56 (1982); *Kensington Nat. Bank v. Cedarbrook Country Club*, 54 A.2d 838 (1947).

<sup>60</sup> Section 1.40(21) (§ 4-33-140(2)).

<sup>61</sup> Section 6.03 (§ 4-33-603).

<sup>62</sup> Sections 8.04 and 6.40 (§§ 4-33-804 and 4-33-640).

<sup>63</sup> See, for example, the following sections: 3.04 (§ 4-33-304) (right to sue for certain ultra vires acts); 6.10 (§ 4-33-610) (differences in rights); 6.21 (§ 4-33-621) (right to fair and reasonable termination, expulsion and suspension procedure); 6.30 (Section 6.30 was not enacted by Arkansas) (right to bring derivative suits); 7.05 (§ 4-33-705) (right to notice of meetings of members); 7.20 (Arkansas enacted a different version of this section at § 4-33-720) and 16.02 (Section 16.02 was not enacted by Arkansas) (right to membership list) 7.21 (§ 4-33-721) (voting entitlement generally); 16.02 (Section 16.02 was not enacted by Arkansas) (inspection of records); 16.20 (Section 16.20 was not enacted by Arkansas) (right to financial statements); and 16.21 (Section 16.21 was not enacted by Arkansas) (report of indemnification).

<sup>64</sup> Section 2.02(a) (5) (§ 4-33-202(a) (5)).

authority of members.<sup>65</sup> The delegates may also exercise some or all of the powers of the board of directors.<sup>66</sup>

**4. The Revised Act (§ 4-33-101 et seq.) requires the articles of incorporation to include provisions for distribution of assets on dissolution of the corporation, thereby preventing subsequent confusion and conflict.**

The Old Act did not require the articles to make a provision for distribution of corporate assets on dissolution. This has led to disputes as to who should receive the assets upon corporate dissolution.<sup>67</sup> The problem does not arise if the articles of a business corporation fail to provide for distribution of its assets on dissolution. When it dissolves, its net worth is distributed to its shareholders. Under the Old Act there is considerable uncertainty as to who would receive the assets of a nonprofit corporation if its articles or bylaws did not make provision for distribution of its assets upon dissolution.

Under the Revised Act (§ 4-33-101 et seq.) the members of a public benefit or religious corporation are not entitled to its assets on dissolution.<sup>68</sup> However, the members of a mutual benefit corporation may receive its assets when it dissolves.<sup>69</sup>

The Revised Act (§ 4-33-101 et seq.) does not require the articles to state to whom the assets of a nonprofit corporation will be distributed upon its dissolution. It simply requires the incorporators to consider the question and make some provision in the articles of incorporation for disposition of the corporate assets upon dissolution.<sup>70</sup> The dissolution clause may specify a specific organization or organizations to receive the assets on dissolution or authorize an individual, organization or the board of directors to determine who will receive the assets upon dissolution.

**5. Courts may authorize nonprofit corporations to hold meetings of members, directors or delegates when it would otherwise be impossible or impractical to do so.**

Nonprofit corporations frequently have difficulty holding meetings because they have set an unrealistically high quorum, cannot identify their members, have improperly elected directors or are otherwise unable to comply with bylaw or statutory requirements for holding meetings. The Revised Act (§ 4-33-101 et seq.) provides a solution to these problems. Pursuant to section 1.60 (§ 4-33-160), courts may set temporary rules allowing a corporation to hold a meeting and thereafter continue its activities when it would otherwise be impractical or impossible to do so.

**6. The Revised Act (§ 4-33-101 et seq.) sets standards of care and loyalty and protects directors who meet these standards.**

The Old Act did not set forth standards of care or loyalty for directors of nonprofit corporations. Consequently the Old Act could not and did not exonerate directors who acted properly in meeting their fiduciary obligations. There has been no consensus on the standards that should be applicable to directors of nonprofit corporations. Some commentators have suggested trust standards, while others have suggested business standards.<sup>71</sup>

The Subcommittee had little difficulty in rejecting trust standards and adopting the same general language the MBCA (§ 4-2 7-101 et seq.) uses for directors of business corporations.<sup>72</sup> The Subcommittee believed that there was enough flexibility in that language to allow for the exigencies of nonprofit corporations.<sup>73</sup>

In 1986, after the Revised Act (§ 4-33-101 et seq.) was distributed for comment,

<sup>65</sup> Section 6.40 (§ 4-33-640).

<sup>66</sup> Section 8.01(c) (§ 4-33-801(c)).

<sup>67</sup> See *In Re Los Angeles County Pioneer Soc.* 40 C.2d 852, 257 P.2d 1 (1953), *Lynch v. Spilman*, 67 Cal.2d 291, 62 Cal. Rptr. 12, 431 P.2d 636 (1967).

<sup>68</sup> But see note 12.

<sup>69</sup> Section 14.06(a) (7) (§ 4-33-1406(a) (7)).

<sup>70</sup> Section 2.02(a) (6) (§ 4-33-202(a) (6)).

<sup>71</sup> See the cases and authorities cited in "Duties of Charitable Trust, Trustee and Charitable Corporation Directors," *Real Property, Probate and Trust Journal* 545 (1967).

<sup>72</sup> Section 8.30 (§ 4-33-830) and Official Comment to Section 8.30 (§ 4-33-830).

<sup>73</sup> *Id.*



Delaware adopted provisions limiting the monetary damages that could be recovered from directors of business corporations who breached their duty of care.<sup>74</sup> Other states quickly adopted similar provisions in their corporate laws.<sup>75</sup> Some states also adopted statutes limiting liability of nonprofit corporations.<sup>76</sup>

In 1987, the Subcommittee decided to provide an alternative section 8.30 (§ 4-33-830), limiting the monetary damages recoverable from directors of nonprofit corporations who breach their duty of care. The alternative section allows states to follow the Delaware approach in a manner which is consistent with the rest of the Revised Act (§ 4-33-101 et seq.).

The question of what conflict of interest provisions to apply to nonprofit corporations raised difficult and perplexing questions. In most cases, transactions between a nonprofit corporation and its directors benefit the corporation. Many nonprofit organizations want officers of financial institutions or landlords on their board to help obtain otherwise unavailable loans or leases.

Unfortunately, there are numerous examples of directors taking advantage of nonprofit corporations. It could be argued that directors of nonprofit corporations should not have more stringent self-dealing rules than directors of business corporations. It also could be argued that the directors of nonprofit corporations, like trustees, should not enter into any self-dealing transactions and should not profit in any way from their position as directors. There is merit in both arguments. In

resolving the dilemma, the Subcommittee was not unmindful of Learned Hand's statement that "Justice, I think, is the tolerable accommodation of the conflicting interests of society..."<sup>77</sup>

The division of nonprofit corporations into public benefit, mutual benefit and religious was helpful in resolving the conflict of interest dilemma. Of the three types of nonprofit corporations, mutual benefit corporations are the most like business corporations. The Subcommittee therefore decided to apply MBCA (§ 4-27-101 et seq.) conflict of interest language to directors of mutual benefit corporations.<sup>78</sup>

The Act (§ 4-33-101 et seq.) applies a different rule to directors of public benefit and religious corporations.<sup>79</sup> These corporations rely on the public's perception that they are worthy of trust and do more than operate with "the morals of the market place."<sup>80</sup> Consequently, the business rule was not adopted for public benefit and religious corporations. The rule which was adopted validates conflict of interest transactions presented to the board in advance for approval if the facts are known or fully disclosed and if the directors approving the transaction "in good faith reasonably believe that the transaction is fair to the corporation."<sup>81</sup> If the transaction was properly approved by the board, it is not necessary to show the transaction was in fact fair to the corporation, simply that the directors acting in good faith reasonably believed it to be fair to the corporation.<sup>82</sup>

Section 8.31 (The version of section 8.31 enacted by Arkansas differs from the Re-

<sup>74</sup> Del. Gen. Corp. Law Section 102(b) (7).

<sup>75</sup> See Calif. Corp Code Section 204(a) (10); New York Bus. Corp Law Section 402(b).

<sup>76</sup> See New York N.P.C.L. Section 720-a; Mass. Gen Laws. Ch. 180, Section 3.

<sup>77</sup> Quoted by Hamburger, "The Great Judge," *Life*, November 4, 1976, pages 120 and 125.

<sup>78</sup> Section 8.31(c) (The version of section 8.31 enacted in Arkansas differs from the Revised Act.).

<sup>79</sup> Section 8.31(b) (The version of section 8.31 enacted in Arkansas differs from the Revised Act.).

<sup>80</sup> See *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928).

<sup>81</sup> Section 8.31(b) (1) (ii) (The version of section 8.31 enacted in Arkansas differs from the Revised Act.). A conflict of interest transaction may also be approved by a committee of the board, the attorney general or an appropriate court. Section 6.31(b) (Section 6.31 was not enacted by Arkansas.).

<sup>82</sup> See the Official Comment to section 8.31 (The version of section 8.31 enacted in Arkansas differs from the Revised Act.).

vised Act) is designed to allow the boards of nonprofit corporations to distinguish between the good and the bad, while not putting the directors in jeopardy if they act in good faith with full knowledge or after full disclosure of the relevant facts.

**7. The Revised Act (§ 4-33-101 et seq.) balances the right of members to inspect membership lists and the right of the corporation to protect a valuable corporate asset.**

Members can inspect and copy membership lists under the Revised Act (§ 4-33-101 et seq.).<sup>83</sup> However, membership lists, unlike shareholder lists, provide a valuable list of the names and addresses of contributors, members and supporters. Allowing membership lists to be used for improper purposes could be exceedingly harmful to nonprofit corporations. This is particularly true for public benefit corporations whose membership lists are valuable corporate assets that often set forth the identity of important donors.

To protect against abuse, section 16.05 (not enacted by Arkansas) places limits on the use of membership lists. However, the Revised Act (§ 4-33-101 et seq.) also protects members rights by allowing them access to membership lists in struggles for corporate control and in internal policy disputes, subject to court imposed limits to prevent abuse.

**8. The Revised Act (§ 4-33-101 et seq.) provisions on accounting records and reports are appropriate for corporations which often have few assets.**

The Revised Act (§ 4-33-101 et seq.)

requires corporations to "maintain appropriate accounting records".<sup>84</sup> The Revised Act (§ 4-33-101 et seq.), unlike the MBCA (§ 4-27-101 et seq.), does not require that annual financial statements be sent to members.<sup>85</sup> Nonprofit corporations are small and impecunious. For them the cost of printing and mailing an annual report out-weighs the benefits of receiving the report. If yearly financial reports are important, they may be required by a duly adopted bylaw provision.

A nonprofit corporation upon receiving a written demand from a member, must furnish that member with its latest annual financial statements.<sup>86</sup> The statements do not have to be prepared on the basis of generally accepted accounting principles, but if the corporation prepares its reports on that basis, the statements must also be prepared on that basis.<sup>87</sup> In appropriate cases, a member may also inspect the financial records of the corporation.<sup>88</sup>

**9. The Revised Act (§ 4-33-101 et seq.) facilitates voting by members and the holding of membership meetings.**

Membership meetings of nonprofit corporations, although similar to shareholder meetings, have significant differences. For example, the MBCA and other business laws usually provide for minimum quorum requirements. The Revised Act (§ 4-33-101 et seq.) allows a quorum to be any percentage or number set by the bylaws.<sup>89</sup> The bylaws may even provide that the person or persons attending a meeting comprise a quorum.<sup>90</sup> In the absence of a contrary article or bylaw provi-

<sup>83</sup> Sections 7.20 (§ 4-33-720) and 16.02(b) (Section 16.02 was not enacted by Arkansas). However, the articles and bylaws of religious corporations may limit the right of members to inspect and copy membership lists. Sections 7.20(f) (54-33-720(f) and 16.02(e) (Section 16.02 was not enacted by Arkansas.).

<sup>84</sup> Section 16.01(b) (§ 4-33-1601(b)).

<sup>85</sup> Compare section 16.20 of the Revised Act (Section 16.20 was not enacted by Arkansas) with section 16.20 of the MBCA (§ 4-27-1620).

<sup>86</sup> Section 16.20 (Section 16.20 was not enacted by Arkansas.). However, the articles or bylaws of a religious corporation may eliminate the right of members to receive the latest annual financial statement. Section 16.20(a) (Section 16.20 was not enacted by Arkansas.).

<sup>87</sup> Section 16.20(a) (Section 16.20 was not enacted by Arkansas.).

<sup>88</sup> Section 16.02(b) (Section 16.02 was not enacted by Arkansas.). However, the articles and bylaws of a religious corporation may eliminate the right of members to inspect financial records. Section 16.02(e) (Section 16.02 was not enacted by Arkansas.).

<sup>89</sup> Section 7.22(a) (§ 4-33-722(a)).

<sup>90</sup> See Official Comment to section 7.22 (§ 4-33-722).



sion, the minimum quorum is ten percent of the voting power.<sup>91</sup>

If a corporation has a low quorum, some protection is needed to prevent a small minority from taking over an annual meeting and voting on unnoticed matters. The Revised Act (§ 4-33-101 et seq.) provides this protection by allowing only those matters described in the meeting notice to be voted upon at an annual meeting unless at least one-third of the voting power is present.<sup>92</sup>

Many nonprofit corporations do not use a record date, or use it differently than business corporations. Business corporations use the record date as a cutoff date for determining those members entitled to receive notice of, and to vote at, meetings. Some nonprofit corporations use it the same way. Others use it merely as the date to determine those members entitled to receive notice of meetings; members who join after the record date, but before the meeting, are allowed to vote. This approach is authorized by the Revised Act (§ 4-33-101 et seq.).<sup>93</sup>

The MBCA (§ 4-27-101 et seq.) authorizes the giving notice of shareholder meetings by mail.<sup>94</sup> This is the normal method of giving notice and is also authorized by the Revised Act (§ 4-33-101 et seq.).<sup>95</sup> However, a number of nonprofit organizations give notice by posting or by some method not traditionally used by business corporations. Under certain circumstances the Revised Act (§ 4-33-101 et seq.) validates such nontraditional methods of giving notice.<sup>96</sup>

One small but significant improvement in the Revised Act (§ 4-33-101 et seq.) allows notice of meetings to be given in a nonprofit corporation's magazine or other publications.<sup>97</sup> This saves the cost of a separate mailing.

Business corporations and nonprofit corporations have annual and special meetings of members. In addition, some nonprofit corporations have regular meetings of members. Significant corporate decisions may be made at these regular meetings. The Revised Act (§ 4-33-101 et seq.) provides special rules to authorize and govern regular meetings.<sup>98</sup>

**10. The Revised Act (§ 4-33-101 et seq.) sets forth indemnification and insurance provisions to protect directors, officers, employees and agents of nonprofit corporations.**

The Revised Act (§ 4-33-101 et seq.) contains extensive provisions relating to indemnification, advances for expenses and insurance.<sup>99</sup> The provisions cover directors, officers, employees and agents of nonprofit corporations and are based on the analogous provisions of the MBCA (§ 4-27-101 et seq.).<sup>100</sup>

When the Old Act was adopted in 1964, there was little perceived need to provide in detail for indemnification, advances for expenses and insurance.<sup>101</sup> Today, directors and officers of nonprofit corporations are concerned about personal liability and the cost of defending themselves if they are sued.

Consequently the Revised Act (§ 4-33-101 et seq.) not only authorizes and sets standards for indemnification, but indicates who and under what circumstances indemnification may be provided. Mandatory indemnification is required in a limited number of cases. In addition the Revised Act (§ 4-33-101 et seq.) allows a corporation to pay or reimburse reasonable expenses incurred in defending an action and allows a director to seek court ordered indemnification.

<sup>91</sup> Section 7.22(a) (§ 4-33-722(a)).

<sup>92</sup> Section 7.22(d) (§ 4-33-722(d)).

<sup>93</sup> Section 7.07 (§ 4-33-707).

<sup>94</sup> MBCA sections 1.41 and 7.05 (§§ 4-27-141 and 4-27-705).

<sup>95</sup> Sections 1.41 and 7.05 (§§ 4-33-141 and 4-33-705).

<sup>96</sup> Section 7.05 (§ 4-33-705), also see Official Comment to Section 7.05 (§ 4-33-705).

<sup>97</sup> Section 1.41(f) (§ 4-33-141(f)).

<sup>98</sup> Section 7.01 (§ 4-33-701).

<sup>99</sup> Sections 8.50-8.58 (§§ 4-33-850 — 4-33-858).

<sup>100</sup> See MBCA sections 8.50-8.58 (§§ 4-27-850 — 4-27-858).

<sup>101</sup> Compare section 5 (f) of the old Act with sections 8.50-8.58 of the Revised Act (§§ 4-33-850 — 4-33-858).

**Official Comment to Section 1.01 (A.C.A. § 4-33-101)**

The short title provides a common name for use in referring to the state's nonprofit corporation act (§ 4-33-101 et seq.).

The Introduction to the Model Act (§ 4-33-101 et seq.) provides a general back-

ground and description of the Act (§ 4-33-101 et seq.), its basic approach, and significant additions and changes from the last revision of the Model Act.

**Official Comment to Section 1.02 (A.C.A. § 4-33-102)**

States may amend the Model Act (§ 4-33-101 et seq.) from time to time without violating any rights a corporation has as a result of the Act's (§ 4-33-101 et seq.) statutory provisions. While section 1.02 (§ 4-33-102) may not be necessary, it lays to rest concern that cases like *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat) 518 (1819) may have vitality today. That case held that a state could

not apply a new statute to an existing corporation and suggested that a reservation of power provision might have allowed the court to uphold the new statute. By setting forth a reservation of power provision section 1.02 (§ 4-33-102) allows the legislature to amend the Model Act's (§ 4-33-101 et seq.) provisions without concern for the vested rights argument.

**Official Comment to Section 1.20 (A.C.A. § 4-33-120)**

"Section 1.20 standardizes the filing requirements for all documents required or permitted by the Model Act to be filed with the secretary of state. In a few instances, other sections of the Act impose additional requirements which must also be complied with if the document in question is to be filed. Section 1.20 relates only to documents which the Model Act expressly requires or permits to be filed with the secretary of state; it does not authorize or direct the secretary of state to accept or reject for filing other documents relating to corporations and does not treat documents required or permitted to be filed under other statutes.

"The purposes of the filing requirements of chapter 1 are:

(1) to simplify the filing requirements by the elimination of formal or technical requirements that serve little purpose,

(2) to minimize the number of pieces of paper to be processed by the secretary of state, and

(3) to eliminate all possible disputes between persons seeking to file documents and the secretary of state as to the legal efficacy of documents.

"The requirements of section 1.20 may be summarized as follows:

**"1. Form**

"To be eligible for filing, a document must be typed or printed and in the English language (except to the limited ex-

tent permitted by section 1.20(e)). The secretary of state is not authorized to prescribe forms (except to the extent permitted by section 1.21) and as a result may not reject documents on the basis of form (see section 1.25) if they contain the information called for by the specific statutory requirement and meet the minimal formal requirements of this section.

**"2. Execution**

"To be filed a document must simply be executed by a corporate officer.... No specific corporate officer is designated as the appropriate officer to sign though the signing officer must designate his office or the capacity in which he signs the document. Among the officers who are expressly authorized to sign a document is the ...[presiding officer] of the board of directors, a choice that may be appropriate if the corporation has a board of directors but has not appointed officers. If a corporation has not been formed or has neither officers nor a board of directors, an incorporator may execute the document.

"The requirement in earlier versions of the Model Act and in many state statutes that documents must be acknowledged or verified as a condition for filing has been eliminated. These requirements serve little purpose in connection with documents filed under corporation statutes. (See in this connection section 1.29, which makes it a criminal offense for any person to sign



a document for filing with knowledge that it contains false information.) On the other hand, many organizations, like lenders or title companies, may desire that specific documents include acknowledgements, verification, or seals; section 1.20(g) therefore provides that the addition of these forms of execution does not affect the eligibility of the document for filing.

### **"3. Contents**

"A document must be filed by the secretary of state if it contains the information required by the Model Act. The document may contain additional information or statements and their presence is not ground for the secretary of state to reject the document for filing. These documents must be accepted for filing even though the secretary of state believes that the language is illegal or unenforceable. In view of this very limited discretion granted to secretaries of state under this section, section 1.25(d) defines the secretary of state's role as 'ministerial' and provides that no inference or presumption arises from the fact that the secretary of state accepted a document for filing. See the Official Comments to sections 1.25 and 1.30.

### **"4. Number of Copies**

"Section 1.20(i) requires that a docu-

ment filed with the secretary of state must be accompanied by 'one exact or conformed copy.' The requirement in early versions of the Model Act and in many state statutes that 'duplicate originals' (each being executed as an original document) be submitted has been eliminated. Under section 1.20(i) an 'exact' copy is a reproduction of the executed original document by photographic or xerographic process; a 'conformed' copy is a copy on which the existence of signatures is entered or noted on the copy. The substitution of exact or conformed copies for duplicate originals reflects advances in the art of office copying machines that permit the routine reproduction of exact copies of executed documents. However, a person submitting 'duplicate originals' meets the requirement of this section since the secretary of state may treat the duplicate original as a 'conformed copy.' The reasons for requiring an exact or conformed copy of a filed document to accompany the signed original, and the processing of these documents by the secretary of state, are discussed in the Official Comment to Section 1.25." Official Comment to Section 1.20 of the Model Business Corporation Act (§ 4-27-120)."

## **Official Comment to Section 1.21 (A.C.A. § 4-33-121)\***

"As described in the Official Comment to section 1.20, documents are entitled to filing under the Model Act if they meet the substantive and formal requirements of the Act; they may also contain additional information if the person submitting the document so elects. See the Official Comments to sections 1.20 and 1.25. In these circumstances it is not appropriate to vest the secretary of state with general authority to establish mandatory forms for use under the Model Act. Certain types of reports and requests for documents may be processed efficiently only if uniform forms are prescribed by the secretary of state. Certificates of existence, for example, should require specific information located at specific places on the form; similarly, processing of large-volume, largely routine filings is expedited if standardized forms are required. Also, the

disclosure requirements of the annual report may be administered on a systematic basis if a standardized form is mandated. Section 1.21(a) recognizes that these considerations may exist in limited cases, and expressly enumerates those forms for which the secretary of state is authorized to establish mandatory forms.

"Section 1.21(b) authorizes (but does not require) the secretary of state to prepare forms suitable for use for other documents required or permitted to be filed under the Act. However, the use of these forms is permissive and cannot be required by the secretary of state." Official Comment to Section 1.21 of the Model Business Corporation Act (§ 4-27-121).

\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 1.22 (A.C.A. § 4-33-122)\***

"Section 1.22 establishes in a single section the filing fees for all documents that may be filed under the Model Act. The dollar amounts for each document should be inserted by each state as it adopts the Act.

"The list of documents in section 1.22 includes all documents that are authorized to be filed with the secretary of state under the Model Act. The catch-all in subdivision (26) will apply to any document for which a state does not establish a specific filing fee plus any document that later amendments to the statute may authorize or direct be filed with the secretary of state without establishing a specific filing fee.

"Subdivision (9) states that no fee is applicable to filing the resignation of a registered agent. This provision permits a person who is named as a registered agent without his consent, or who agrees to

serve as registered agent for a fee and the fee is not paid, to eliminate any reference to himself in the records of the secretary of state without expense.

"Subdivision (8) contains a maximum fee for filing a change of address of a registered agent. Since corporation service companies serve as registered agents for thousands of corporations in many jurisdictions, their change of address may require a very large number of filings. Hence, the fee is broadly based on the number of corporations affected but a maximum fee is specified to reflect that as the number of changes increases the cost per change should decrease." Official Comment to Section 1.22 of the Model Business Corporation Act (§ 4-27-122).

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\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 1.23 (A.C.A. § 4-33-123)**

"Section 1.23(a) provides that documents accepted for filing become effective at the time and date of filing, or at another specified time on that date, unless a delayed effective date is selected under section 1.23(b). This section gives express statutory authority to the common practice of most secretaries of state of ignoring processing time and treating a document as effective as of the date it is submitted for filing even though it may not be reviewed and accepted for filing until several days later.

"Section 1.23(a) requires secretaries of state to maintain a date and time stamp for recording the receipt of documents and provides that documents become effective at the stamped time on the date of filing. This provision should eliminate any doubt about situations involving same-day transactions in which documents, for example articles of merger, are filed on the morning of the date the merger is to

become effective. Section 1.23(a) contemplates that the time of filing, as well as the date, will be routinely recorded.

"Section 1.23(b) provides an alternative method of establishing the effective date of a document. The document itself may fix as its effective date any date within 90 days after the date it is filed; it may also fix the time it becomes effective on that date. If no time is specified, the document becomes effective as of the close of business on the specified date. The Model Act also allows the effective date fixed in a document to be corrected to a limited extent. See the Official Comment to Section 1.24.

"Section 1.23(b) does not authorize or contemplate the retroactive establishment of an effective date before the date of filing." Official Comment to Section 1.23 of the Model Business Corporation Act (§ 4-27-123).

**Official Comment to Section 1.24 (A.C.A. § 4-33-124)**

"Section 1.24 permits making corrections in filed documents without refileing the entire document or submitting formal articles of amendment. This correction procedure has two advantages: (1) filing

articles of correction may be less expensive than refileing the document or filing articles of amendment, and (2) articles of correction do not alter the effective date of the underlying document being corrected.



Indeed, under section 1.24(c), even the correction relates back to the original effective date of the document except as to persons relying on the original document and adversely affected by the correction. As to these persons, the effective date of articles of correction is the date the articles are filed.

"A document may be corrected either

because it contains an 'incorrect statement' or because it was defectively executed (including defects in optional forms of execution that do not affect the eligibility of the original document for filing)." Official Comment to Section 1.24 of the Model Business Corporation Act (§ 4-27-124).

### Official Comment to Section 1.25 (A.C.A. § 4-33-125)

#### ***"1. Filing Duty in General***

"Under section 1.25 the secretary of state is required to file a document if it 'satisfies the requirements of section 1.20.' This language should be contrasted with earlier versions of the Model Act (and many state statutes) that required the secretary of state to ascertain whether the document 'conformed with law' before filing it. The purpose of this change is to limit the discretion of the secretary of state to a ministerial role in reviewing the contents of documents. If the document submitted is in the form prescribed and contains the information required by section 1.20 and the applicable provision of the Model Act, the secretary of state under section 1.25 must file it even though it contains additional provisions the secretary of state may feel are irrelevant or not authorized by the Model Act or by general legal principles. Consistently with this approach, section 1.25(d) states that the filing duty of the secretary of state is ministerial and provides that filing a document with the secretary of state does not affect the validity or invalidity of any provision contained in the document and does not create any presumption with respect to any provision. Persons adversely affected by provisions in a document may test their validity in a proceeding appropriate for that purpose. Similarly, the attorney general of the state may also question the validity of provisions of documents filed with the secretary of state in an independent suit brought for that purpose; in neither case should any presumption or inference be drawn about the validity of the provision from the fact that the secretary of state accepted the document for filing.

#### ***"2. Mechanics of Filing***

"Section 1.25(b) provides that when the secretary of state files a document, he stamps or endorses it as filed, retains the

signed original document for his records, and returns the exact or conformed copy (which must accompany the document under section 1.20(i)) to the corporation or its representative with the secretary of state's fee receipt or acknowledgement of receipt if no fee is required. This will establish that a document has been filed in the form of the copy. Consideration was given to dispensing with the document copy entirely and providing only for the return of a fee receipt or equivalent document. Several states currently follow this practice with respect to articles of incorporation and other documents. It was felt to be important, however, to continue a practice by which each corporation receives back from the secretary of state for its records a document that on its face shows that it is an exact or conformed copy of the document that was filed with the secretary of state. This copy is usually placed in the minute book and is available for informal inspection without requiring a person to examine the records of the secretary of state. Of course, a person desiring a certified copy of any filed document may obtain it from the office of the secretary of state by paying the fee prescribed in section 1.22(c).

#### ***"3. Elimination of Certificates of Incorporation and Similar Documents***

"Section 1.25(b) provides that acceptance of articles of incorporation or other documents is evidenced merely by the issuance of a fee receipt or acknowledgement of receipt if no fee is required. Earlier versions of the Model Act and the statutes of many states provided that acceptance by the secretary of state is evidenced by a 'certificate' (e.g., of incorporation, of merger, or of amendment). This older practice was not retained in the revised Model Act because it was felt desirable to reduce the number of pieces of paper issued by the secretary of state.

Under the older practice most state offices routinely issued both fee receipts and certificates. A single document—the fee receipt or acknowledgement—should sufficiently indicate that the document has been accepted for filing, and in fact many states in recent years have dispensed with the formal certificate.

***“4. Rejection of Document by Secretary of State***

“Because of the simplification of formal filing requirements and the limited discretion granted to the secretary of state by

the Model Act it is probable that rejection of documents for filing will occur only rarely. Section 1.25(c) provides that if the secretary of state does reject a document for filing he must return it to the corporation or its representative within five days together with a brief written explanation of this reason for rejection. This rejection may be the basis of judicial review under section 1.26.” Official Comment to Section 1.25 of the Model Business Corporation Act (§ 4-27-125).”

**Official Comment to Section 1.26 (A.C.A. § 4-33-126)**

***“1. The Court With Jurisdiction to Hear Appeals From the Secretary of State***

“The identity of the specific court with jurisdiction to hear appeals from the secretary of state under section 1.26 must be supplied by each state when enacting this section. It is intended that this should be a court of general civil jurisdiction. It may either be the court located in the capital of the state or the court in the county where the corporation’s principal business office is located in the state or, if the corporation does not have a principal office in the state, the court located in the county in which its registered office is located. The annual report of the corporation must state where the principal office of the corporation (which need not be within the state) is located. See section 16.22 (not enacted by Arkansas). Other sections of the Model Act also contemplate that the court with jurisdiction over substantive corporate matters will be designated in the statute.... It is expected that jurisdiction over litigation with respect to substantive matters will normally be vested in the court in the county of the corporation’s principal or registered office. See the Official Comment to section 7.03.

***“2. ‘Summary’ Orders***

“In view of the limited discretion of the secretary of state under the Act, a ‘summary’ order appears to be appropriate in section 1.26. Throughout the Model Act the term ‘summarily order’ or similar language is used where courts are authorized to order action taken and the person charged with taking the original action has little or no discretion. The word ‘summary’ is not used in a technical sense but to refer to a class of cases where the court might appropriately order that action be taken on the face of the pleadings or after an oral hearing but without any need to resolve disputed factual issues.

***“3. Burden of Proof and Review Standard***

“The revised Model Act, unlike earlier versions, does not address either the burden of proof or the standard for review in judicial proceedings challenging action of the secretary of state. It is contemplated that these matters will be governed by general principles of judicial review of agency action in each adopting state.” Official Comment to Section 1.26 of the Model Business Corporation Act (§ 4-27-126).”

**Official Comment to Section 1.27 (A.C.A. § 4-33-127)**

“The secretary of state may be requested to certify that a specific document has been filed with him upon payment of the fees specified in section 1.22(c). Section 1.27 provides that the certificate is conclusive evidence only that the original document is on file. The limited effect of

the certificate is consistent with the ministerial filing obligation imposed on the secretary of state under the Model Act.” Official Comment to Section 1.27 of the Model Business Corporation Act (§ 4-27-127).”



**Official Comment to Section 1.28 (A.C.A. § 4-33-128)\***

"Section 1.28 establishes a procedure by which anyone may obtain a conclusive certificate from the secretary of state that a particular domestic or foreign corporation is in existence or is authorized to transact business in the state. The certificate will probably be a standardized form. The secretary of state is to make the judgment whether or not the corporation is in existence or is authorized to transact business from public records only and is not expected to make a more extensive investigation. In appropriate cases, the secretary of state may issue a certificate subject to specified qualifications.

"[Section 1.28(b) (3)] refers only to taxes, fees, or penalties collected by the secretary of state or collected by other agencies and reported to the secretary of state. In some states the secretary of state may ascertain from other agencies that franchise or other taxes have been paid

and include this information in the certificate. In states where this procedure does not unduly delay the issuance of certificates, section 1.28 may be revised appropriately. [Section 1.28(b) (3)] relates only to taxes, fees, or penalties to the extent their nonpayment affects the existence or authorization to transact business of the corporation.

"A certificate of existence or authorization that may be relied on as binding and conclusive is of material assistance to attorneys who may be required to give formal legal opinions in connection with corporate transactions." Official Comment to Section 1.28 of the Model Business Corporation Act (§ 4-27-128)."

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\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 1.29 (A.C.A. § 4-33-129)**

"Section 1.29 makes it a criminal offense for any person to sign a document that he knows is false in any material respect with intent that the document be submitted for filing to the secretary of state.

"Section 1.29(b) is keyed to the classifi-

cation of offenses provided by the Model Penal Code. If a state has not adopted this classification, the dollar amount of the fine should be substituted for the misdemeanor classification." Official Comment to Section 1.29 of the Model Business Corporation Act (§ 4-27-129)."

**Official Comment to Section 1.30 (A.C.A. § 4-33-130)**

"Section 1.30 is intended to grant the secretary of state the authority necessary for his efficient performance of the filing and other duties imposed on him by the Act but is not intended to give him general authority to establish public policy. The most important aspects of a modern corporation statute relate to the creation and maintenance of relationships among persons interested in or involved with a corporation; these relationships basically should be a matter of concern to the parties involved and not subject to regulation or interpretation by the secretary of state. Further, even in situations where it is claimed that the corporation has been

formed or is being operated for purposes that may violate the public policies of the state, the secretary of state generally should not be the governmental official that determines the scope of public policy through administration of this filing responsibilities under the Act. Rather, the attorney general may seek to enjoin the illegal conduct or to dissolve involuntarily the offending corporation.

"Section 1.30 is more narrowly drafted than earlier versions of the Model Act and the statutes of many states." Official Comment to Section 1.30 of the Model Business Corporation Act (§ 4-27-130)."

**Official Comment to Section 1.40 (A.C.A. § 4-33-140)\***

With a few exceptions, all the definitions in the Model Act (§ 4-33-101 et seq.) are set forth in section 1.40 (§ 4-33-140). A few “special definitions” appear in subchapters or sections to which they apply.

The following is a discussion of some of the more important definitions:

**1. *Approved by (or Approval by) the Members*** (§ 4-33-140(1))

This definition (§ 4-33-140(1)) sets forth the minimum statutory requirements for having a matter approved by the members. Approval may be by a vote of the members at a membership meeting or by written ballot or written consent. Compare sections 7.01, 7.02, 7.08 and 7.04 (§§ 4-33-701, 4-33-702, 4-33-708 and 4-33-704).

To be approved by the members the following minimum conditions must be met:

1. A quorum must be present. See section 7.22 (§ 4-33-722). Presence may be established by physical presence, presence by proxy or by signing a written consent or written ballot.

2. A majority of the votes represented and voting must vote in favor of a proposal. While abstentions may be counted in the quorum, abstentions are not counted as no votes in determining whether a majority of the votes have been cast in favor of approving a proposal.

3. The votes cast for a proposal must constitute a majority of the required quorum.

The following example illustrates the interplay of these requirements. A quorum is a majority of the votes entitled to be cast. Assume the number of votes entitled to be cast is 100, the number of votes present is 60. If 26 votes are cast in favor of a proposal, 17 against the proposal and 17 abstain, the proposal is approved. The 26 votes for the proposal constitute a majority of the required quorum of 51. If, however, there are 25 votes in favor of a proposal, 12 against the proposal and 23 abstain, the proposal is defeated. The 25 votes for the proposal are not a majority of the required quorum. Consequently the proposal is defeated even though the number of affirmative votes is greater than the number of negative votes.

In addition to the minimum require-

ments, the Model Act (§ 4-33-101 et seq.) or a corporation’s articles or bylaws may mandate a higher vote or a vote by class or some other unit or grouping. If so, unless the relevant article or bylaw provision contravenes a Model Act (§ 4-33-101 et seq.) requirement, a matter can not be approved by the members unless it is approved by the higher vote.

**2. *Board or Board of Directors*** (§ 4-33-140(3))

The definition of board of directors (§ 4-33-140(3)) distinguishes between the board of directors and the group or groups to which the articles may delegate some or all of the powers of the board. See section 8.01(c) (§ 4-33-801(c)). Such groups are not treated as the board for purposes of the Model Act (§ 4-33-101 et seq.). They do, however, assume the duties and responsibilities of the board insofar as they have been delegated some or all of the powers of the board. Section 8.01(c) (§ 4-33-801(c)).

**3. *Bylaws*** (§ 4-33-140(4))

The term “bylaws” has a particularly expansive definition. The term refers to the code or codes of rules, other than the articles, adopted for regulation or management of corporate affairs regardless of the name by which such rules are designated.

**4. *Delegates*** (§ 4-33-140(7))

Professional associations, churches, political parties and numerous other organizations hold representative assemblies from time to time at which major corporate and policy decision are made. These representative assemblies may be called conventions, annual meetings or some other name. See sections 1.40(7) and 6.40 (§§ 4-33-140(7) and 4-33-640). The people elected or appointed to vote at these representative assemblies are “delegates” for purposes of the Model Act (§ 4-33-101 et seq.) even if they are called by some other name.

**5. *Distribution*** (§ 4-33-140(11))

“Distribution” is defined in section 1.40(10) (§ 4-33-140(11)) as “the payment of a dividend or any part of the income or profit of a corporation to its members, directors or officers.” The payment of any part of the income or profit of a corporation to its members, directors or officers does not include:

(i) the payment of compensation in a



reasonable amount to its members, directors or officers for services rendered; or

(ii) conferring benefits upon its members in conformity with its purposes.

This definition (§ 4-33-140(11)) is based on and represents no substantive change from section 26 of the prior version of the Model Nonprofit Corporation Act.

#### **6. Member** (§ 4-33-140(22))

A "member" is a person who is given the right under a corporation's articles or bylaws to vote for a director or directors of the corporation. See section 1.40(21) (§ 4-33-140(22)). Whenever the Model Act (§ 4-33-101 et seq.) refers to members it is referring to them based on the definition set forth in section 1.40(21) (§ 4-33-140(22)). If a person is called a member by a nonprofit corporation, but does not have the right to vote for directors, that person is not a member for the purposes of the Model Act (§ 4-33-101 et seq.). Persons who can not vote for directors but are called members, associates, affiliates or some other name may have common law or other rights. The question of what rights they have is left to a state by state determination.

A corporation is not required to have "members." Once it has decided to have such members, these members are afforded basic protections and rights by the Model Act (§ 4-33-101 et seq.). People who have the right to vote for directors are treated as members for Model Act (§ 4-33-101 et seq.) purposes regardless of the name by which they are called.

As a result of section 1.40(21) (§ 4-33-140(22)) three categories of people who select directors are not treated as members by the Model Act (§ 4-33-101 et seq.). Section 1.40(21) (§ 4-33-140(22)) provides that a person is not a member because of any rights that person has as a delegate. Therefore, a delegate who votes for directors is not a member. A person may be a delegate and a member if he or she has the right to vote for directors and that right does not arise out of that person's rights as a delegate.

The Model Act (§ 4-33-101 et seq.) does not treat delegates as members for two reasons. The first reason is practical. The Act (§ 4-33-101 et seq.) provides notice and other rights to members on the assumption that the members can always be identified. Often delegates are not identified until they appear or are accredited at a convention. By that time it is often too

late to fulfill notice and other procedural requirements of the Model Act (§ 4-33-101 et seq.). Moreover there is the question of how long a person remains a delegate and what a delegate's role is between conventions. The law in this area is unclear and in an early stage of development. It would be premature to write statutory rules when there is no consensus as to what the law should be. See section 6.40 (§ 4-33-640) which recognizes and legitimizes the role delegates play.

The fact that the Model Act (§ 4-33-101 et seq.) does not provide specific rights to delegates does not mean that delegates are without rights. A corporation's articles or bylaws or a state's common law may prescribe rules governing delegates and their rights and obligations.

Some individuals or public and other entities that want the right to appoint directors do not or legally cannot become members of nonprofit corporations. Therefore, the Model Act (§ 4-33-101 et seq.) provides that the articles or bylaws of a corporation may authorize any person to appoint a director and that the person is not made a member as a result of appointing a director. See sections 1.40(21) and 8.04 (§§ 4-33-140(22) and 4-33-804). Certain protections are provided to people who have the right to appoint directors. See sections 8.09, 8.10 and 10.30 (§§ 4-33-809, 4-33-810 and 4-33-1030). Persons appointing directors may have additional rights as a result of article or bylaw provisions, negotiated agreements with the corporation, or state common law.

Directors are the third category of persons who select directors, but are not members. Directors who select other directors have adequate protection in their capacity as directors and should not be treated as members.

#### **7. Membership** (§ 4-33-140(23))

The term "membership" is defined as the totality of rights and obligations a member or members may have arising out of the articles, bylaws or the Model Act (§ 4-33-101 et seq.). It does not include rights and obligations that may arise out of contractual or other obligations. Two or more persons may hold one membership.

#### **8. Mutual Benefit Corporation** (§ 4-33-140(24))

See the Introduction to the Model Act (§ 4-33-101 et seq.) for a discussion of mutual benefit corporations. Section 1.40(23) (§ 4-33-140(24)) distinguishes

between corporations existing before and those formed on or after the effective date of the Model Act (§ 4-33-101 et seq.). Corporations formed on or after the effective date as mutual benefit corporations must provide in their articles that they are mutual benefit corporations. Section 17.07 (§ 4-33-1707) requires certain corporations existing prior to the effective date to be mutual benefit corporations.

**9. Principal Office** (§ 4-33-140(27))

Section 16.22 (not enacted by Arkansas) requires each nonprofit corporation to designate a principal office. Section 1.40(26) (§ 4-33-140(27)) defines a principal office as the office designated in the annual report as the place where the corporation's principal offices are located. The place designated as a principal office should be the place, if any, that is the center of the corporation's activities. For many nonprofit corporations there is no place which is really the center of their activities. These corporations may designate the office or home of an officer as their principal office.

**10. Public Benefit Corporation** (§ 4-33-140(29))

See the Introduction to the Model Act (§ 4-33-101 et seq.) for a discussion of public benefit corporations. Section

1.40(28) (§ 4-33-140(29)) distinguishes between corporations existing before and those formed on or after the effective date of the Model Act (§ 4-33-101 et seq.). Corporations formed on or after the effective date as public benefit corporations must provide in their articles that they are public benefit corporations. Section 17.07 (§ 4-33-1707) requires certain corporations existing prior to the effective date to be public benefit corporations.

**11. Religious Corporation** (§ 4-33-140(31))

See the Introduction to the Model Act (§ 4-33-101 et seq.) for a discussion of religious corporations. Section 1.40(30) (§ 4-33-140(31)) distinguishes between corporations existing before and those formed on or after the effective date of the Model Act (§ 4-33-101 et seq.). Corporations formed on or after the effective date as religious corporations must provide in their articles that they are religious corporations. Section 17.07 (§ 4-33-1707) requires certain corporations existing prior to the effective date to be religious corporations.

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\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 1.41 (A.C.A. § 4-33-141)\***

Section 1.41 (§ 4-33-141) sets forth the rules for determining the effective date of notices given under the Model Act (§ 4-33-101 et seq.).

Unless the Act (§ 4-33-101 et seq.) otherwise provides, notice may be oral or written. Oral notice is effective when communicated in a comprehensible manner. Written notice must be in a comprehensible form to be effective. The effective date of written notice depends on the means used to send the written notice. Written notice is effective when received or at any of the following times if they are earlier:

1. Five days after the notice is deposited in the United States mail correctly addressed with first class postage;

2. On the date shown on the signed return receipt for mail sent by registered or certified mail; or

3. Thirty days after the notice is deposited in the United States mail correctly addressed with other than first class postage.

As a result of the above rules nonprofit corporations can be sure of the effective date of a mailing even if the mail does not reach the intended person. The Model Act (§ 4-33-101 et seq.) recognizes that many nonprofit corporations have special mailing privileges. These organizations can send their mail at the nonprofit rate; the effective date of any such mailing is thirty days after the mail is deposited in the United States mail.

Many nonprofit corporations include notices in newsletters, magazines or other publications regularly sent to members. Subsection (f) (§ 4-33-141(f)) allows notices or reports contained in such publications to constitute written notice. If more than one member has the same address on the corporation's current records and lives in the same household as other members, notice in a publication delivered or mailed to such member at the correct address serves as written notice to all the members at the same address.



Other provisions of the Act (§ 4-33-101 et seq.) may override the rules set forth in section 1.41 (§ 4-33-141). See section 1.41(h) (§ 4-33-141(h)). Moreover if a corporation's articles or bylaws provide different notice requirements, those requirements, if not inconsistent with the Act (§ 4-33-101 et seq.), are valid. For exam-

ple, bylaws may provide more stringent notice requirements for a meeting of the board than those set forth in section 8.22 (§ 4-33-822).

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 1.50 (A.C.A. § 4-33-150)\***

Under section 508(e)(1) of the Internal Revenue Code, a private foundation (as defined in section 509(a)) is not exempt from federal income tax under section 501(a) unless its governing instrument includes provisions the effects of which are:

(1) to require its income for each taxable year to be distributed at such time and in such manner as not to subject the foundation to tax under section 4942; and

(2) to prohibit the foundation from engaging in any act of self-dealing (as defined in section 4941(d)), from detaining any excess business holdings (as defined in section 4943(c)), from making any investments in such manner as to subject the foundation to tax under section 4944, and from making any taxable expenditures (as defined in section 4945(d)).

Section 1.508-3(d) of the Income Tax Regulations provides that a private foundation's governing instrument is deemed to conform with the requirements of section 508(e) of the Code if valid provisions of state law have been enacted which either require the foundation to comply with the provisions of section 508(e)(1), or treat the required provisions as contained in the foundation's governing instrument.

Section 508(e)(2) of the Code provides that the requirements of paragraph 1 of

the section do not apply to a foundation organized before January 1, 1970 which has been excused from complying with the requirements of paragraph 1 by a court order secured in a proceeding begun before January 1, 1972.

Under the applicable Income Tax Regulation (section 1.508(3)(d)), section 1.50 (§ 4-33-150) requiring a corporate foundation to comply with the provisions of section 508(e) of the Code satisfies the requirement that a foundation's governing instrument include such provisions. The section (§ 4-33-150) applies only to foundations which are corporations, and does not satisfy the requirements of section 508(e) in the case of trusts or other entities which qualify as private foundations under section 509(a) of the Code.

The introductory clause "Except where otherwise provided by a court of competent jurisdiction" incorporates the exception specified under paragraph 2 of section 508(e) for foundations organized prior to January 1, 1970 which have been relieved from the requirements of paragraph 1 by a timely judicial proceeding.

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 1.60 (A.C.A. § 4-33-160)**

Section 1.60 (§ 4-33-160) provides an escape valve allowing nonprofit corporations to conduct meeting or obtain the consent of members, delegates or directors when it is otherwise impractical or impossible to do so. For example, a corporation may have a high quorum requirement preventing it from holding a meeting of members because the required number of members won't attend a meeting. It may have inaccurate records and be unable to

identify its members or directors. The section (§ 4-33-160) allows directors, officers, delegates, members or the attorney general to petition the appropriate court for an order allowing the members or directors to vote or hold a meeting even if the order dispenses with requirements of the Model Act (§ 4-33-101 et seq.), the articles or bylaws concerning voting or holding meetings. The court in exercising its discretion should provide a procedure

that is fair and equitable under all the circumstances.

Judicial relief should not be granted under this section (§ 4-33-160) if the nonprofit corporation has duly adopted a viable method for holding meetings or obtaining consent. In a hierarchical church, for example, the church hierarchy may be empowered to determine the manner of holding meetings or obtaining consent.

Whenever practical the court order should limit the matters considered to those matters which will allow the corporation to continue its activities without

further resort to section 1.60 (§ 4-33-160). Once the impediment to member or director action is removed, the members and directors can act without court aid.

If the corporation cannot locate or identify the members or directors, the court is empowered to authorize notice by any method reasonably designed to give actual notice even if the method does not result in actual notice or comply with the notice requirements that would otherwise apply. In appropriate cases, notice to members or directors may be by publication. See section 1.41(b) (§ 4-33-141(b)).

### Official Comment to Section 1.70\*

Subsection (a) requires that the attorney general be given notice of any proceeding that could have been brought by the attorney general, but is commenced by another person. Subdivision (b)(1) grants the attorney general independent authority to act when notice is required under subsection (a) or any other provision of the Model Act (§ 4-33-101 et seq.). This carries out the policy implicit in such notice requirements by specifically empowering the attorney general to protect the public interest when it may be adversely affected. Subdivision (b)(2) permits the attorney general to intervene in any proceeding that the attorney general could

have commenced but that was brought by another person, such as a director, or member. To protect the public interest, the attorney general may either commence a proceeding or intervene in a proceeding commenced by another person who is authorized to do so.

Section 1.70 does not detract from the jurisdiction the attorney general may otherwise have in states adopting the Model Act (§ 4-33-101 et seq.).

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\*This section was not enacted by Arkansas.

### Official Comment to Section 1.80 (A.C.A. § 4-33-180)

As a result of history, policy, and constitutional principles, religious corporations are entitled to protections not available to business or other nonprofit corporations. Courts have been reluctant to interfere with the internal affairs of religious organizations. They will not decide between conflicting religious doctrine or determine the "true" faith. However, courts have often decided internal property disputes by applying neutral principles of contract or corporate law to organizational documents of religious organizations. See Mansfield, "The Religious Clauses of the First Amendment and the Philosophy of the Constitution," 72 *Calif. L. Rev.* 847 (1984); Ellman, "Driven from the Tribunal: Judicial Resolution of Internal Church Disputes," 69 *Calif. L. Rev.* 1878 (1981).

This reluctance is based in part on the

First Amendment to the United States Constitution which provides: "Congress shall make no law respecting an establishment of religion, or prohibiting the exercise thereof...." The establishment clause applies to states [*Everson v. Board of Education*, 330 U.S. 1 (1947)], as does the free exercise clause [*Cantwell v. Connecticut*, 310 U.S. 296 (1940)]. The Model Act (§ 4-33-101 et seq.) attempts to walk the thin line between the establishment clause and the free exercise clause. It allows religious corporations to be formed and given them the same rights and privileges as other corporations. The Model Act (§ 4-33-101 et seq.) avoids interfering with the free exercise of religion by negating or allowing religious corporations to negate provisions of the Model Act (§ 4-33-101 et seq.) that might result in excessive entanglement in religious activities



by the state. By limiting state intrusion the Model Act (§ 4-33-101 et seq.) uses the least restrictive means to provide an orderly structure in which religious corporations can be formed and operate.

Section 1.80 (§ 4-33-180) is based on the recognition that some provisions of the Model Act (§ 4-33-101 et seq.) may conflict with the United States Constitution or state constitutions. The exact scope of constitutional limitations is less than clear and is subject to debate. Section 1.80 (§ 4-33-180) overcomes this difficulty by providing that to the extent religious doctrine applicable to a religious corporation sets forth provisions inconsistent with provisions of the Model Act (§ 4-33-101 et

seq.), the religious doctrine law shall control to the extent required by the United States Constitution or applicable state constitutions. Section 1.80 (§ 4-33-180) was derived from 15 Pa. C.S.A. section 7106.

While in one sense section 1.80 (§ 4-33-180) simply states the obvious, it is helpful to remind those dealing with the religious corporations that they must consider constitutional mandates. The approach of section 1.80 (§ 4-33-180) also allows a case-by-case determination of difficult questions and automatically conforms the Model Act (§ 4-33-101 et seq.) to the opinions of the United States Supreme Court and the applicable state courts.

### Official Comment to Section 2.01 (A.C.A. § 4-33-201)

Section 2.01 (§ 4-33-201) allows one or more persons to incorporate a corporation by delivering to the secretary of state the articles of incorporation. The term "person" is broadly defined in section 1.40(25) (§ 4-33-140(26)) to allow a wide variety of individuals or entities to serve as incorporators. Anyone serving as an incorporator must sign the original of the articles of incorporation. Sections 1.20(f), (g), and 2.02(c) (§§ 4-33-120(f), 4-33-120(g), and 4-33-202(c)).

Section 1.20(i) (§ 4-33-120(i)) requires an original and one exact or conformed copy of the articles to be delivered to the secretary of state. An "exact" copy is a photographic or similar reproduction of the executed original articles. A "conformed" copy is a copy of the original

articles on which the existence of any signature or signatures is noted. The prior law required delivery of "articles of incorporation in duplicate" to the secretary of state. While this is no longer a requirement, a person submitting duplicate originals to the secretary of state would meet the requirement of having filed an original and a "conformed" copy.

An exact or conformed copy of the articles is required so that the incorporator(s) will have a record of the incorporation. See the Official Comment to Section 2.03 (§ 4-33-203).

In addition to filing the articles, the incorporators are authorized to complete the formation of the corporation as set forth in section 2.05 (§ 4-33-205).

### Official Comment to Section 2.02 (A.C.A. § 4-33-202)\*

#### 1. Introduction

Section 2.02 (§ 4-33-202) allows a simple one- or two-page document to serve as a corporation's articles of incorporation. While there are numerous standard provisions that must be contained in the articles, there is no single standard form of articles.

Section 2.02 (§ 4-33-202) requires certain provisions to be in the articles of incorporation and allows the articles to contain other optional provisions. If no limitation is placed on the duration of the corporation and no optional provisions are contained in the articles, the corporation

will have perpetual existence, the purposes set forth in section 3.01 (§ 4-33-301) and the broad powers enumerated in section 3.02 (§ 4-33-302). However, as a result of sections 2.02(b) (3) (ii) and 3.02 (§§ 4-33-202(b) (3) (ii) and 4-33-302), a corporation may limit its duration and corporate powers.

To meet the requirements of Internal Revenue Code section 501 or equivalent state tax provisions, the articles of many nonprofit corporations must contain limitations on corporate activity and restrictions on the use and distribution of corporate assets. In addition, the articles of all

nonprofit corporations must contain provisions dealing with the disposition of corporate assets on dissolution.

## 2. Required Provisions

The articles of incorporation must contain the following information:

(a) A corporate name that meets the requirements of section 4.01 (§ 4-33-401).

(b) A statement that the corporation is a public benefit, a mutual benefit or a religious corporation. This election requires those forming a nonprofit corporation to choose between public benefit, mutual benefit and religious status at the time of incorporation. See the Introduction to the Model Act (§ 4-33-101 et seq.) for comments on the significance of this distinction. This election will avoid confusion as to the status of nonprofit corporations under the Model Act (§ 4-33-101 et seq.). See *Los Angeles County Pioneer Society v. Historical Society of Southern California*, 40 Cal. 2d 852, 257 P.2d 1 (1953); *Lynch v. Spilman*, 67 Cal. 2d 251, 62 Cal. Rptr. 12, 431 P.2d 636 (1967). Assets held by public benefit and religious corporations may not be distributed to members, directors, officers or controlling persons in violation of section 13.01 (§ 4-33-1301) and may only be distributed on dissolution as set forth in section 14.06 (§ 4-33-1406). If a mutual benefit corporation holds assets in charitable trust, the same limitations apply to distribution of those assets. Other assets held by mutual benefit corporations may not be distributed to members, directors, officers or controlling persons until the corporation dissolves. See chapter 13 (§ 4-33-1301 et seq.) that governs distributions.

(c) The address of the corporation's initial registered office and the name of its initial registered agent.

(d) The name and address of each incorporator.

(e) Whether or not the corporation will have members. The term "members" has a limited meaning which is set forth in section 1.40(17) (§ 4-33-140(18)). Many nonprofit corporations do not have members. They operate with a self-perpetuating board of directors, delegates, or some other system. Those corporations that will not have members must so indicate in their articles. Those corporations that will have members must indicate that there will be members. However, the bylaws and not the articles usually set forth the

characteristics, qualifications, rights, limitations and obligations of the members. See initial Comment 3(c) (ii) regarding optional provisions setting forth rights and obligations of members.

(f) The disposition of assets on dissolution. A nonprofit corporation, unlike a business corporation, must provide for the distribution of its assets on dissolution. If a business corporation dissolves, its net worth will be distributed to its shareholders. Upon dissolution of a nonprofit corporation, its assets are not necessarily distributed to its members. In fact, the assets of public benefit and religious corporations and organizations that have section 501(c) (3) status generally cannot be distributed to members. See chapter 13 (§ 4-33-1301 et seq.) and section 14.06 (§ 4-33-1406).

Some provision for distribution must be set forth in a corporation's articles. There are a wide variety of dissolution provisions ranging from those specifying a specific organization to those authorizing the directors to choose any organization or to choose among various organizations or types of organizations. A dissolution provision must be consistent with the type of tax exempt status the corporation is seeking.

## 3. Optional Provisions

Section 2.02(b) (§ 4-33-202(b)) allows the articles to contain a number of optional provisions. In determining whether to insert an optional provision in the articles, a person forming a corporation should consider the advantages and disadvantages of making the provision subject to public scrutiny, the procedure necessary to amend articles, and the requirements of federal and state income and property tax laws.

Optional provisions include:

(a) A broad or a limited purpose clause. To obtain tax exempt status under federal and state law, many nonprofit corporations will elect to limit their corporate purpose. As the tax laws differ for various types of organizations and change from time to time, it is not feasible to mandate particular limitations. Those forming a corporation, however, should be careful not to limit the purposes or impose more limitations than required by the tax laws unless they have a particular reason to do so. For example, while it may be necessary to irrevocably dedicate assets of a section



501(c) (3) organization to charitable, educational, or certain other activities, it may not be necessary to irrevocably dedicate a corporation's assets to such purposes in order to obtain other exempt status. By irrevocably dedicating assets when such dedication is not required, the incorporators may inadvertently impress the assets of a corporation with unintended restrictions and obligations.

While a narrow purpose clause may serve to identify the essence of the corporation, a narrow purpose clause may unduly restrict corporate activity. For example, if the articles limit the corporate purpose to operating a hospital, the corporation may not be able to only operate outpatient clinics. See *Queen of Angels Hospital v. Younger*, 66 Cal. App. 3d 359, 136 Cal. Rptr. 36 (1977).

(b) The names and addresses of the individuals who are to serve as initial directors. Section 2.02(c) (§ 4-33-202(c)) requires all individuals named as initial directors to sign the articles to evidence their consent to serving as directors. This requirement prevents people from being named as initial directors without their consent. This problem is more acute in nonprofit corporations than in business corporations. In nonprofit corporations incorporators sometimes name respected or famous individuals as directors in the hope that they will serve as directors.

If initial directors are named in the articles, they have the powers set forth in section 2.05 (§ 4-33-205) and may continue to serve as directors subject to being replaced as set forth in the Model Act

(§ 4-33-101 et seq.) or the bylaws of the corporation.

(c) Provisions not inconsistent with law regarding management or regulation of the affairs of the corporation including:

(i) Defining, limiting, and regulating the powers of the corporation, its directors and members. It is not necessary to set forth any corporate powers enumerated in the Act (§ 4-33-101 et seq.). See Section 3.02 (§ 4-33-302).

(ii) The characteristics, qualifications, rights, limitations, and obligations of the members. Typically, provisions relating to members' rights and obligations are set forth in the bylaws of a corporation and not in its articles. This is for two reasons. First, it allows membership provisions to be contained in a private or semi-private document and not in the articles that are filed with the secretary of state. Second, amendments to the articles always require a vote of members which may be cumbersome and time consuming. Compare sections 10.01-10.08 (§§ 4-33-1001 — 4-33-1008) with sections 10.20-10.22 (§§ 4-33-1020 — 4-33-1022). Thus, more privacy and greater flexibility are obtained by putting membership provisions in bylaws.

(iii) Any provision that under the Act (§ 4-33-101 et seq.) is required or permitted to be set forth in the bylaws. See the Official Comment to Section 2.06 (§ 4-33-206).

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\*The version of this section enacted by Arkansas differs from the Model Act.

### Official Comment to Alternative Section 2.02(b)(5)\*

States which desire to adopt alternative section 8.30 should also adopt section 2.02(b) (5).

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\*This alternative section was not enacted by Arkansas.

### Official Comment to Section 2.03 (A.C.A. § 4-33-203)

#### 1. Corporate Existence

Unless a delayed effective date is specified, a de jure corporation is formed when the secretary of state files the articles. Section 2.03(a) (§ 4-33-203(a)). Typically, the articles are stamped and dated as "filed" when they are delivered to the secretary of state even if internal proce-

dures of the secretary of state require additional processing time. See section 1.25 (§ 4-33-125). Those forming a corporation may, however, request that the corporation's existence begin at a specified time following delivery of the articles to the secretary of state. Section 2.03(a) (§ 4-33-203(a)).

## 2. Proof of Incorporation

Pursuant to section 2.03(b) (§ 4-33-203(b)), the secretary of state's filing of the articles is conclusive proof that all condi-

tions precedent to incorporation have been met except in a proceeding brought by the state.

### Official Comment to Section 2.04 (A.C.A. § 4-33-204)

There is a wide variety of factual situations in which third parties seek to impose liability on persons purporting to act as or on behalf of a corporation that has not been formed. There are numerous situations in which such liability would lead to an unjust result. This is particularly true in the nonprofit area where corporations are not operated for personal gain and where members are often less sophisticated than shareholders.

At one extreme, section 2.04 (§ 4-33-204) by implication protects individuals who erroneously and in good faith believe that a corporation has been formed. At the other extreme, section 2.04 (§ 4-33-204) imposes liability on individuals who purport to act as or on behalf of a corporation knowing that it has not been formed and knowing that the party with whom they

are dealing believes a corporation exists. In the myriad of factual patterns falling between these extremes, a court may deny recovery when it is equitable to do so after considering all the circumstances. For example, if a third party insisted that a contract be signed on behalf of a corporation knowing that the corporation had not been formed, a court could apply equitable principles and not impose personal liability on the individual who signed the contract.

Even if personal liability is appropriate, it should not be imposed on all members of the corporation. Not all members of nonprofit unincorporated associations are necessarily liable for the obligations of the association. See *Libby v. Perry*, 311 A.2d 527 (Me. 1973); *Steuer v. Phelps*, 41 Cal. App. 3d 468, 116 Cal. Rptr. 61 (1974).

### Official Comment to Section 2.05 (A.C.A. § 4-33-205)

Section 2.05 (§ 4-33-205) provides alternative ways to complete the process of incorporation.

If initial directors have been named in the articles; they may complete the organization of the corporation at a meeting or by unanimous written consent. Sections 2.05(a) and 8.21 (§§ 4-33-205(a) and 4-33-821). There is no reason to name initial "dummy" directors as the same function can be carried out and privacy maintained by use of incorporators.

The completion of the organization typically includes opening a bank account, applying for federal and state tax-exempt status, electing officers, adopting bylaws, providing for and admitting members, if any, applying for licenses from state and local authorities, obtaining an employer identification number, registering with

the attorney general or other state authorities, and entering into arrangements and contracts for ongoing operations.

If initial directors have not been named in the articles, the incorporators at an organizational meeting may elect directors and complete the organization of the corporation. Section 2.05(a) (2) (§ 4-33-205(a) (2)). In completing the organization, incorporators should act with caution as they are responsible for their actions.

If no organizational meeting is held, the incorporators may act by signing a written approval of the actions they take. Section 2.05(b) (§ 4-33-205(b)). This procedure should be followed rather than preparing minutes of a meeting that does not take place.

### Official Comment to Section 2.06 (A.C.A. § 4-33-206)

A nonprofit corporation is required to adopt bylaws. The term "bylaws" has a broad meaning. See section 1.40(3) (§ 4-33-140(3)). Failure to adopt bylaws will

lead to much confusion and uncertainty about the internal structure and organization of the corporation. However, failure to adopt bylaws will not affect the de jure



status of a corporation.

The bylaws may contain any provision regulating and managing the affairs of the corporation not inconsistent with law or the articles. If a nonprofit corporation has members, its bylaws frequently contain detailed provisions dealing with their characteristics, qualifications, rights, limitations and obligations. Such provisions may relate to voting rights, procedures governing admission, expulsion, suspension and other matters. The bylaws may either specify the exact number of directors or specify that the number of directors may be fixed within a stated range by the board or the members. Additional provisions that may appear in bylaws include: provisions for distribution of assets on dissolution in addition to those required by the articles (see section 2.02(a) (7)) (§ 4-33-202(a) (7)); levying dues, fees

and assessments; setting the fiscal year; notice and the mechanics of meetings of directors and members; indemnification of officers, directors and agents; conventions and appointing delegates, if any; the authority of the officers and the executive director, if any; procedures to be followed in regard to checks and bank accounts; keeping and inspecting corporate records; and provisions, not inconsistent with the Model Act (§ 4-33-101 et seq.) or articles, for amending the bylaws.

The incorporators or initial directors should adopt the initial bylaws of a corporation prior to the admission of members. The Model Act (§ 4-33-101 et seq.) contains specific procedures that must be followed to amend the bylaws or to repeal them and adopt new bylaws. See sections 10.20-10.22 (§§ 4-33-1020 — 4-33-1022).

### **Official Comment to Section 2.07 (A.C.A. § 4-33-207)**

In the absence of an article provision to the contrary, the directors may adopt, amend or repeal bylaws to be effective only in the event of an emergency. Emergency bylaws are normally adopted prior to the existence of the emergency as defined in section 2.07(d) (§ 4-33-207(d)). An emergency exists if a quorum of a corporation's directors cannot readily be achieved because of a catastrophe. A catastrophe could include an attack upon the United States or a serious fire or flooding that makes it difficult or impossible to obtain a quorum of the board. The emergency bylaws may provide special

procedures necessary for managing the corporation during the emergency.

To provide incentive for adoption of emergency bylaws, section 2.07(c) (§ 4-33-207(c)) provides that action taken in good faith in accordance with the emergency bylaws binds the corporation and may protect directors, officers, employees and agents of the corporation from liability.

Even if a corporation does not adopt emergency bylaws it may still exercise the powers set forth in section 3.03 (§ 4-33-303) in the event of an emergency as defined in section 3.03(d) (§ 4-33-303(d)). See section 3.03 (§ 4-33-303).

### **Official Comment to Section 3.01 (A.C.A. § 4-33-301)**

#### **1. Introduction**

Public benefit corporations operate for some public or charitable purpose, while religious corporations operate primarily or exclusively for religious purposes. Mutual benefit corporations act on behalf of their members or those they hold themselves out as representing or benefiting. The Model Act (§ 4-33-101 et seq.) requires an election between public benefit, mutual benefit and religious status and allows each type of nonprofit corporation to engage in any lawful activity unless a narrower purpose clause is set forth in its articles. See section 2.02 (§ 4-33-202) and

the Introduction to the Model Act (§ 4-33-101 et seq.).

The failure to set forth an explicit limitation on a nonprofit corporation's activities does not mean that an enterprising entrepreneur can improperly and with impunity operate in the nonprofit form. In general, public benefit and religious corporations cannot make distributions to members or controlling persons. Section 13.01 (§ 4-33-1301). Unreasonable compensation cannot be paid to members or controlling persons. See Official Comment to Section 13.01 (§ 4-33-1301). In addition, the attorney general has broad pow-

ers to ensure that a public benefit corporation is not operating for the private benefit of any individual. Section 1.70 (not enacted by Arkansas). Religious corporations are subject to minimal attorney general supervision.

Mutual benefit corporations cannot pay unreasonable compensation, but can make distributions to members or controlling persons upon dissolution, and are subject to less extensive attorney general supervision than public benefit corporations. An entrepreneur might try to establish a mutual benefit corporation without members and distribute its assets to himself upon dissolution. He should be prevented from doing so if the corporation led those from whom it received funds into believing that the corporation was operating for a public or charitable purpose, or that its assets would only be used for the benefit of those it represented or those to whom it provided goods or services. A court should find that the assets of the corporation may not be diverted for the personal benefit of a controlling person.

While section 3.01 (§ 4-33-301) does not impose any limitations on a corporation's purposes or the use of its assets, those forming nonprofit corporations may limit the corporate purposes in the articles of incorporation. Such limitations may be

added to obtain tax exempt status, to attract a significant contribution, or to provide a limited purpose for a corporation. See the Official Comment to Section 2.02 (§ 4-33-202) for a discussion of the dangers involved in narrowing a corporation's purpose or powers. Also see section 3.04 (§ 4-33-304) dealing with the ultra vires concept.

## **2. Other Statutes**

A nonprofit corporation may incorporate pursuant to chapter 2 unless some other state statute or law prohibits incorporation or sets forth some condition to forming the nonprofit corporation. If so, incorporation is prohibited or may only take place after the condition has been met. Section 3.01(b) (§ 4-33-301(b)). For example, it may be necessary to obtain the consent of some regulatory body prior to incorporating.

Many nonprofit corporations are subject to regulation as a result of the nature of their activities. Hospitals, colleges, secondary schools and health maintenance organization, for example, are subject to extensive regulation. Section 3.01(b) (§ 4-33-301(b)) provides that nonprofit corporations continue to be subject to applicable statutory provisions even though they have broad corporate purposes.

## **Official Comment to Section 3.02 (A.C.A. § 4-33-302)\***

Section 3.02 (§ 4-33-302) is an historic anomaly. In the nineteenth and early twentieth centuries corporate charters were granted for limited purposes. As corporation laws began to develop, they listed ad nauseam specific powers to overcome the problem of limited purpose corporations.

There was considerable sentiment on the Committee to simply have section 3.02 (§ 4-33-302) provide that corporations have the powers of an individual to do all things necessary or convenient to carry out their activities. However, in light of history, it was feared that a court might improperly conclude that a corporation lacked some power because it was not specifically set forth in the Model Act (§ 4-33-101 et seq.). In addition, there was some concern that attorneys might revert to the ill-advised practice of enumerating powers in articles of incorporation. Consequently, section 3.02 (§ 4-33-

302) provides a broad grant of powers and sets forth a nonexclusive list of specific powers.

As a result of section 3.02 (§ 4-33-302), it is not necessary for a corporation to provide in its articles or bylaws that it has any particular powers. If nothing is said, a corporation automatically has the powers set forth in section 3.02 (§ 4-33-302).

In some instances, it may be desirable or necessary to limit corporate powers. Section 3.02 (§ 4-33-302) allows the articles of incorporation to limit the powers of a corporation. Limitations may be imposed to obtain federal or state tax status, because a grantor wishes to limit the activities of a corporation, or for some other reason. Persons forming or operating a nonprofit corporation may want to limit its powers.

A distinction should be drawn between the power of a corporation to do all things necessary or convenient to carry out its



activities and the question of whether corporate acts are reasonable or otherwise prohibited. Section 1.50 (§ 4-33-150), for example, prohibits private foundations from taking certain actions, even though they have the power to do so. Similarly, unless limited by its articles of incorporation, a corporation has the power to guarantee performance of a contract, enter into a partnership, make political or other noncharitable contributions, but the directors in authorizing such actions may breach their duty of care or loyalty. See sections 8.30-8.33 (§§ 4-33-830 — 4-33-833).

The following changes from and clarifications of the prior law should be noted:

(1) Nonprofit corporations can provide pension and other benefits to current and former directors, officers, employees and agents. Section 3.02(11) and (12) (§ 4-33-302(11) and (12)). Under appropriate circumstances the board of directors may establish or change benefits for former employees.

(2) Nonprofit corporations have the power to make donations for public welfare or for charitable, scientific, or educational purposes and for other purposes, not inconsistent with law, to further the corporate interests. Section 3.02(13) (§ 4-33-302(13)). This specific grant of power is not a limitation on the general power of nonprofit corporations to make the same donations individuals can make.

(3) Nonprofit corporations may impose dues, assessments, admission and transfer fees upon their members. Section 3.02(14) (§ 4-33-302(14)). The fact that articles or bylaws authorize dues, assessments or fees does not necessarily impose liability on members. See sections 6.13-6.15 (§ 4-33-613 — 4-33-615).

(4) Nonprofit corporations have the power to engage in business. Nonprofit organizations operate hospitals, depart-

ment stores, consulting firms, book stores, automobile associations, clearing houses and other activities that could be characterized as business. These activities are within a nonprofit corporation's powers as a result of section 3.02(16) (§ 4-33-302(16)).

The fact that a nonprofit corporation has the power to operate a business does not mean that the corporation is acting properly in running the business. The business must be consistent with or in aid of the public or charitable purposes of a public benefit corporation, benefit the members of a mutual benefit corporation or be consistent with or in aid of the religious purpose of a religious corporation. A corporation that does not operate a business for those purposes can be challenged in a quo warranto or similar proceeding. See *Olsen v. National Memorial Gardens, Inc.*, 115 N.W.2d 312, 366 Mich. 492 (1962); *People v. Society of Good Neighbors*, 42 N.W.2d 761, 327 Mich. 620 (1950); *People v. White Circle League of America*, 97 N.E.2d 811, 408 Ill. 564 (1951). Also see *State v. National Ass'n of Angling & Casting Clubs*, 51 N.E.2d 662 (1943), where profit from business activities was used for the objects of the organization and the court found no wrongful activity.

(5) Nonprofit corporations may establish conditions for admission to membership, admit members and issue memberships. Section 3.02(15) (§ 4-33-302(15)). This provision does not validate all admission requirements but simply provides that a corporation has the power to set conditions. Whether the conditions are legal depends on applicable federal and state law.

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\*The version of this section enacted by Arkansas differs from the Model Act.

### Official Comment to Section 3.03 (A.C.A. § 4-33-303)

Section 3.03 (§ 4-33-303) provides that a corporation has specified powers in the event of an emergency even if emergency bylaws have not been adopted pursuant to section 2.07 (§ 4-33-207). The section

(§ 4-33-303) allows corporations that have not adopted emergency bylaws to continue to operate until the emergency is passed.

**Official Comment to Section 3.04 (A.C.A. § 4-33-304)**

The object of section 3.04 (§ 4-33-304) is to do away with the ultra vires doctrine. This long-discredited concept is based on the fiction that third parties dealing with corporations have constructive notice of limitations on corporate purposes and powers appearing in articles of incorporation. In the heyday of the ultra vires doctrine, innocent third persons or not-so-innocent corporations could have corporate acts and contracts declared void or unenforceable on the ground that they were beyond the corporate purposes or that the corporation had no power to enter into the transaction. Ballentine, "Proposed Revision of the Ultra Vires Doctrine," 12 *Corn. L.Q.* 453 (1927).

Courts developed a number of equitable doctrines to prevent unjust results. Section 3.04(a) (§ 4-33-304(a)) directly attacks the problem by providing that, "except as provided in (b), the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act." Consequently, it is not necessary for a third person to check corporate articles for limitations on corporate purposes or powers; nor, except as provided in subsection (b) (§ 4-33-304(b)), can a corporation avoid an obligation on the ground that the obligation is beyond its purposes or powers.

Under subsection (b) (§ 4-33-304(b)) a suit may be maintained by a member in a derivative proceeding, or a director, or the attorney general against a corporation to enjoin an act where a third party has not acquired rights in regard to the transaction. For example, if a corporation is about to enter into a binding commitment in violation of its articles, a proceeding could be brought to enjoin the corporation if a third party had not acquired any rights. A third party with prior actual knowledge of

the limitation in the articles cannot acquire any rights.

If a corporation has entered into or completed an ultra vires transaction, a proceeding can be brought against the present or former directors, officers, employees, or agents who caused the corporation to act in violation of limitations contained in its articles. In such a situation a third party who had acquired rights could enforce the ultra vires action even though it violated a specific provision of the articles. However, a director approving such a contract would be liable if the director breached his or her duty of care or loyalty. The amount of money damages, if any, for violation of this section is left to the sound discretion of the courts. Similarly the circumstances in which an injunction will issue is left to judicially developed equitable principles.

The focus of section 3.04 (§ 4-33-304) is narrow. It only validates corporate actions that are attacked on the ground that the corporation had no power to act. It does not address actions that: (i) violate other provisions of the Model Act (§ 4-33-101 et seq.); (ii) violate federal or state laws; (iii) breach duties owed by the directors, officers, employees or agents of the corporation; (iv) have not been approved or authorized as required by the Model Act (§ 4-33-101 et seq.); or (v) involve a claim by the corporation or a third party seeking to avoid liability on the ground that the person acting on behalf of the corporation was not authorized to do so or was acting beyond the scope of his agency or agency power; or (vi) breach duties owed by the corporation.

Moreover section 3.04 (§ 4-33-304) does not deal with the authority or power of a corporation to sell, transfer or otherwise convey assets held in charitable trust or subject to a reversionary or other interest.

**Official Comment to Section 4.01 (A.C.A. § 4-33-401)****1. No Requirement to Include "Corporation," "Incorporated," "Company," or "Limited" in Name**

While the Model Business Corporation Act (§ 4-27-101 et seq.) requires business corporations to use the term "corporation," "incorporated," "company," or "limited," or some abbreviation thereof in their names, the prior Model Nonprofit Corporation Act

did not have a similar requirement. Imposition of such a requirement for nonprofit corporations would create two classes of corporations, those formed before and those formed after the effective date of the revised Model Nonprofit Corporation Act (§ 4-33-101 et seq.). This problem could be solved by imposing a name requirement on all nonprofit corporations. This ap-



proach is contrary to nonprofit tradition, would not materially protect the public and would entail considerable effort and cost. Hospitals, colleges, museums, trade associations and other nonprofit institutions usually do not include the words "corporation," "company," "incorporated," or "limited" in their names. Any such addition would sound strange and, particularly in the case of the words "company," and "limited," would not provide any meaningful information. Apart from the basic question of whether any of these words convey the concept of limited liability, nonprofit corporations can effectively undercut any such name requirement by operating under a fictitious name.

## **2. Names Must Be "Distinguishable Upon the Records of the Secretary of State"**

A corporate name must be distinguishable upon the secretary of state's records from other corporate names that appear in the secretary of state's records. This requirement is imposed: "(1) to prevent confusion within the secretary of state's office and the tax office and (2) to permit accuracy in naming and serving corporate defendants in litigation. Thus, confusion in an absolute or linguistic sense is the appropriate test under the Model Act ...." Official Comment to Model Business Corporation Act Section 4.01 (§ 4-27-401).

The fact that the secretary of state files a corporation's articles of incorporation does not give that corporation the right to

use the name set forth in its articles. Whether it can or cannot use the name depends on general principles of fraud and unfair competition. See *American Kennel Club v. American Kennel Club, Inc.*, 216 F. Supp. 267 (D. La. 1963); *Lincoln Center for Performing Arts, Inc. v. Lincoln Center Classics, Record Soc., Inc.*, 25 Misc. 2d 686, 210 N.Y.S.2d 275 (1960); McCarthy, *Trademarks and Unfair Competition* § 9.2 (2d ed. 1984).

A corporation may operate under a fictitious name that is different than the name appearing in its articles of incorporation. Of course, the use of a fictitious name may be prevented under general principles of fraud and unfair competition.

What is "distinguishable upon the records of the secretary of state" is left to the discretion of the secretary of state. This discretion may be challenged pursuant to section 1.26 (§ 4-33-126).

## **3. Consent to Use Name**

Subsection 4.01(c) (§ 4-33-401(c)) allows the secretary of state to authorize the use of a name that is not distinguishable upon the secretary of state's records from the record name of another corporation if that corporation consents in writing and submits a satisfactory undertaking to change its name to one that is distinguishable upon the records of the secretary of state. The undertaking should be consistent with and no broader than the requirements of section 4.01 (§ 4-33-401).

## **Official Comment to Section 4.02 (A.C.A. § 4-33-402)**

Considerable effort is often expended in finding an appropriate name for a nonprofit corporation. Under the Model Act (§ 4-33-101 et seq.) those forming a nonprofit corporation, after determining that a particular name is available, can reserve that name for a nonrenewable 120-day period. The 120-day period should be more than sufficient to form the corporation.

The ability to reserve a name is available to any person and is not dependent on

any particular intent or purpose. The person reserving the name may transfer the reserved name to another person by delivering to the secretary of state a signed notice of the transfer stating the name and address of the transferee.

While a name reservation is not renewable, after the initial reservation period has lapsed, any person, including a person who held the prior reservation, may reserve the name.

## **Official Comment to Section 4.03 (A.C.A. § 4-33-403)**

Section 4.03 (§ 4-33-403) allows a foreign corporation that is not qualified to transact business in a state, to register and thereby reserve its name. In effect, section 4.03 (§ 4-33-403) allows a foreign

corporation to reserve the right to qualify its name if it subsequently decides to do so. Even if a foreign corporation reserves its name, it may be precluded from using its name in the state under unfair compe-

tion or similar concepts. See Official Comment to Section 4.01 (§ 4-33-401).

A foreign corporation may renew its registered name yearly. Thus, the registration provisions of section 4.03 (§ 4-33-403) allow perpetual renewal while the reservation provisions of section 4.02 (§ 4-33-402) allow a single 120-day reservation with the possibility of additional reservations if no one else reserves the name.

A foreign corporation may only register its real corporate name or its corporate name with any change required by section 15.06 (§ 4-33-1506). A foreign corporation that wishes to register a fictitious name may do so by incorporating an inactive domestic or foreign subsidiary using the desired fictitious name.

### **Official Comment to Section 5.01 (A.C.A. § 4-33-501)**

Section 5.01 (§ 4-33-501) is particularly important for nonprofit corporations, many of which are small, have no permanent office, and are difficult to locate. Section 5.01 (§ 4-33-501), by mandating a registered agent and registered office, provides a place where service of process can be made and notices from governmental entities directed.

Section 5.01 (§ 4-33-501) requires all nonprofit corporations to maintain a registered office and a registered agent at the same address. The office may be anywhere in the state. It is a "legal" office and in many cases will not be the same as the

real office, if any, of the corporation. Any person who resides in the state, any domestic nonprofit or business corporation or any foreign nonprofit or business corporation authorized to do business in the state may serve as the registered agent. Many nonprofit corporations will designate an officer or their attorney to act as their registered agent. Nonprofit corporations can employ corporation service companies to act as their registered agent and provide their registered office. The office of the agent will become the registered office of the corporation.

### **Official Comment to Section 5.02 (A.C.A. § 4-33-502)**

Section 5.02 (§ 4-33-502) provides an easy method for changing a registered agent or registered office without the need to obtain board or member approval. The section (§ 4-33-502) requires a newly designated registered agent to sign a written consent to the appointment. This is to ensure that a nonprofit corporation does not appoint someone to serve as registered

agent without informing that person of the appointment and obtaining that person's consent.

Section 5.02(c) (§ 4-33-502(c)) allows a registered agent to change the address of the registered office simply by notifying the corporation and signing and delivering a statement of change to the secretary of state.

### **Official Comment to Section 5.03 (A.C.A. § 4-33-503)\***

Under section 5.03 (§ 4-33-503) a registered agent may resign by delivering to the secretary of state a signed original and two copies of a statement of resignation. The secretary of state will then inform the corporation of the resignation by mailing one copy to the registered office and another copy to the corporation "at its prin-

cipal office shown on its most recent annual report filed under section 16.22." (Section 16.22 of the Model Act was not enacted by Arkansas)

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\*The version of this section enacted by Arkansas differs from the model Act.



**Official Comment to Section 5.04 (A.C.A. § 4-33-504)\***

Section 5.04 (§ 4-33-504) sets forth two nonexclusive ways of serving a corporation with process. A nonprofit corporation can be served by serving its registered agent if it has one. If it has no registered agent, or the registered agent cannot with reasonable diligence be served, the corporation may be served at its principal office as shown on the most recent annual report filed under section 16.22 (not enacted by Arkansas).

Section 5.04 (§ 4-33-504) does not prescribe the only means or necessarily the required means of serving the corporation. A state may have a code of civil procedure or other law providing alternative ways of serving nonprofit corporations.

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\*The version of this section enacted by Arkansas differs from the model Act.

**Official Comment to Section 6.01 (A.C.A. § 4-33-601)**

Section 3.02 (§ 4-33-302) allows, but does not require, a nonprofit corporation to admit members. Any person may be admitted as a member. See section 1.40(21) (§ 4-33-140(22)). As the definition of person contained in section 1.40(25) (§ 4-33-140(26)) is all encompassing, minors, corporations, partnerships, governmental subdivisions and any other person without limitation may be admitted to membership. See New York Not-for-Profit Corporation Law § 601.

Section 3.02(15) (§ 4-33-302(15)) allows corporations to “establish conditions for admission of members” and “admit members.” The requirements for admission are normally set forth in the articles, bylaws or a resolution adopted by the board. These requirements will be upheld unless they conflict with some federal or state law.

Subdivision (b) (§ 4-33-601(b)) prevents corporations from admitting people as members unless they consent to becoming members. Consent may be express or implied. For example, consent may be im-

plied by acceptance of membership benefits knowing that the benefits are only offered to members.

Corporations sometimes name people as members without knowing or having the ability to identify individual members. For example, a corporation’s bylaws may provide that “all poor people within one mile of city hall are members entitled to vote for directors.” In many instances there is no way to prepare a list of these “members” or meet the notice or other requirements of the Model Act (§ 4-33-101 et seq.) as to them, unless they identify themselves to the corporation. As a result of section 6.01 (§ 4-33-601), the above bylaw provision simply authorizes poor people in the area to become members. Before they became members they would have to apply for or consent to joining by attending a meeting, voting or otherwise evidencing consent. Until they had manifested this consent they would not be “members” as that term is defined in section 1.40(21) (§ 4-33-140(22)).

**Official Comment to Section 6.02 (A.C.A. § 4-33-602)**

Issuance of a membership, unlike the sale of stock, does not necessarily involve the sale of something of value. Memberships in public benefit and religious corporations have no economic value, but reflect a contribution or a commitment to participate in or support the organization and its objectives. Memberships in mutual benefit corporations may or may not have an economic value depending on the nature of the organization. Nonprofit corporations need the ability to issue memberships for no consideration or such

consideration as is set forth in or determined by their articles, bylaws, or board. Section 6.02 (§ 4-33-602) provides this flexibility.

Consideration may take any form including but not limited to promissory notes, intangible property, or past or future services. Payment may be made at such times and upon such terms as are set forth in or authorized by the articles, bylaws or a resolution of the board. It may be a fixed amount or based on a formula. For example, in some trade associations

the cost of joining is based on the sales, net worth, or other characteristics of the applicant.

Provisions regarding the amount, nature and time of payment may be set forth in the articles, bylaws or a resolution adopted by the board. Board members in

determining the nature, timing, and amount, if any, of payments are required to fulfill their duty of care and loyalty. The obligation of members to make payments to their corporation is dealt with in section 6.13 (§ 4-33-613).

### **Official Comment to Section 6.03 (A.C.A. § 4-33-603)**

Nonprofit corporations are not required to have members. They may operate with designated or appointed directors, self-perpetuating boards or delegates. See sections 6.40 and 8.04(b) (§§ 4-33-640 and 4-33-804(b)).

Most mutual benefit corporations have members. The members are those persons for whose benefit the corporation operates. There was some sentiment on the Committee to require all mutual benefit corporations to have members. However, numerous mutual benefit corporations serve or represent individuals or entities who pay for the services or representation but have no right to vote for directors. As they have no right to vote for directors,

they are not “members” as that term is used in section 1.40(21) (§ 4-33-140(22)) of the Model Act (§ 4-33-101 et seq.). (The corporation may, however, refer to them as “members.”) A majority of the Committee felt that the Model Act (§ 4-33-101 et seq.) should not prevent mutual benefit corporations from operating with self-perpetuating boards. However, by allowing this flexibility, the Model Act (§ 4-33-101 et seq.) does not affect the duties, if any, the board may have toward those for whose benefit the corporation operates and who pay to support its activities. The nature and the extent of these duties, if any, is left to a case-by-case determination.

### **Official Comment to Section 6.10 (A.C.A. § 4-33-610)**

Section 6.10 (§ 4-33-610) allows great flexibility and diversity in membership rights. In the absence of an applicable article or bylaw provision, all members have the same rights and obligations with respect to voting, dissolution, redemption and transfer. If some members have different rights or obligations in regard to any of these matters, these rights must be set forth in the articles or bylaws and those members comprise a class of members. See section 1.40(5) (§ 4-33-140(5)) which defines class as “a group of memberships that have the same rights with respect to voting, dissolution, redemption and transfer.” A class vote may be required to amend voting, dissolution, redemption or transfer rights. See sections 10.04 and 10.22 (§§ 4-33-1004 and 4-33-1022). Unless the differences as to voting, dissolution, redemption or transfer are set forth in the articles, or bylaws, each member has the same rights and obligations in regard to these matters as every other member.

The articles or bylaws may authorize any person, group or committee to establish different rights and obligations for

different members unless different rights and obligations would create a separate class of members.

The differences may relate to dues, assessments, transfers of memberships in mutual benefit corporations, use of facilities, termination or suspension of members, voting, distributions on dissolution of mutual benefit corporations and other factors. Distinctions can be made between individual, corporate and other entities that are members of the corporation. These distinctions between members can be based on size, net worth, number of employees, activity and other factors. These distinctions do not necessarily result in classes having the right to vote separately on matters requiring a member vote. See sections 10.04 and 10.22 (§§ 4-33-1004 and 4-33-1022).

Federal or state law may prohibit some differences or distinctions. Absent such a law, the underlying philosophy of the Model Act (§ 4-33-101 et seq.) as embodied in section 6.10 (§ 4-33-610) is to authorize great diversity in memberships.

Once members have been admitted, a vote of the members may be required to



change membership rights and obligations. See sections 10.03, 10.04, 10.21 and 10.22 (§§ 4-33-1003, 4-33-1004, 4-33-1021

and 4-33-1022). Members' obligations to the corporation are dealt with in section 6.14 (§ 4-33-614).

### **Official Comment to Section 6.11 (A.C.A. § 4-33-611)**

Subdivision (a) (§ 4-33-611(a)) provides that a membership in a mutual benefit corporation cannot be transferred unless the articles or bylaws provide for transfers. This comports with the reasonable expectations of members of most mutual benefit corporations. A corporation's articles or bylaws may provide for transfers if the members want transferable memberships. The articles or bylaws may impose limitations, conditions, and fees as a condition to transferring memberships.

Subdivision (b) (§ 4-33-611(b)) reinforces the concept that memberships in public benefit and religious corporations are not securities, do not represent a valuable asset, are personal to each member, and should not be sold for value. More-

over, subdivision (b) (§ 4-33-611(b)) prohibits a member of a public benefit or religious corporation from giving a membership to another person. This prevents members from passing membership rights to their friends or relatives without regard to their qualifications.

Subdivision (c) (§ 4-33-611(c)) is particularly important to members of mutual benefit corporations if their memberships represent a valuable asset. It provides that no restriction on transfer can be imposed after the fact without approval of the members and the affected member. A class vote may be required. See sections 10.04, 10.05, 10.21 and 10.22 (§§ 4-33-1004, 4-33-1005, 4-33-1021 and 4-33-1022).

### **Official Comment to Section 6.12 (A.C.A. § 4-33-612)**

Section 6.12 (§ 4-33-612) sets forth the general rule that members have no personal liability to third parties for the corporation's acts, debts, liabilities, or obligations. Following incorporation members have limited liability in the absence of: (i) facts allowing a court to pierce the corpo-

rate veil; or (ii) a legally enforceable obligation of a member to the corporation. See section 2.04 (§ 4-33-204) as to the liability of persons purporting to act as or on behalf of a corporation that has not been formed.

### **Official Comment to Section 6.13 (A.C.A. § 4-33-613)**

Shareholders rarely obligate themselves to make payments to business corporations. Members, particularly members of mutual benefit corporations, often agree to make yearly or other payments for benefits or services provided by non-profit corporations.

The crucial question is whether or not the member agreed or consented to the obligation or knowingly accepted something of value. A member is not obligated to the corporation in the absence of such agreement, consent, or knowing acceptance.

Particularly difficult factual questions may be presented in regard to whether a member has agreed or consented to dues, assessments and fees. Section 6.13 (§ 4-

33-613) provides that an article, bylaw or corporate resolution authorizing dues, assessments or fees is not, by itself, sufficient to impose liability. Some consent or acquiescence is necessary. A member's agreeing to "the corporation's bylaws as they may be amended from time to time" would normally not evidence such consent. Conversely, such consent would normally be shown if a member agreed in writing to "such dues, assessments and fees as the board may from time to time determine" or "as the bylaws may from time to time provide." Under appropriate circumstances consent may be implied from the payment of dues, assessments and fees. The term "fees" includes initiation fees.

**Official Comment to Section 6.14 (A.C.A. 4-33-614)**

Section 6.14 (§ 4-33-614) requires a creditor to obtain a final judgment against a corporation before suing its members unless a proceeding against the corporation would be useless. A proceeding would usually be useless if a corporation was bankrupt or it was obvious that it did not

have sufficient assets to meet the obligation. Section 6.14 (§ 4-33-614) is not intended to preclude the availability of other remedies to a creditor, as, for example, under the Uniform Fraudulent Transfer Act (§ 4-59-201 et seq.).

**Official Comment to Section 6.20 (A.C.A. § 4-33-620)**

Section 6.20(a) (§ 4-33-620(a)) sets forth the basic right of a member to resign from a nonprofit corporation at any time. A nonprofit organization cannot force a person to belong to it. However, a person may be liable to the corporation for wrongfully withdrawing in violation of contractual or other obligations to remain as a member. Under section 6.20(b) (§ 4-33-620(b)) a person may be liable for obligations incurred or commitments made prior to the resignation. These commitments may extend beyond the time the member resigns.

Resignation from membership will not allow a person to avoid liability for goods

or services already provided or for ongoing obligations to which the member agreed prior to resignation. Section 6.20(b) (§ 4-33-620(b)). This provision (§ 4-33-620(b)) is particularly important to corporations that provide benefits or services to members' businesses. The member in joining the organization may promise to use its facilities or services for a specified period of time. While section 6.20(a) (§ 4-33-620(a)) allows a member to resign at any time, section 6.20(b) (§ 4-33-620(b)) allows the corporation to enforce or obtain damages for violation of a member's agreement.

**Official Comment to Section 6.21 (A.C.A. § 4-33-621)**

Section 6.21 (§ 4-33-621) codifies the judicially developed requirement that expulsions, suspensions and terminations in public benefit and mutual benefit corporations must take place by means of a fair and reasonable procedure. Subsection (b) (1) (§ 4-33-621(b) (1)) provides a procedural "safe harbor" for corporations that meet its requirements.

If the "safe harbor" provisions are not met, a court may still uphold the procedural aspects of a termination on the ground that they were "fair and reasonable taking into consideration all the relevant facts and circumstances." Subsection (b) (2) (§ 4-33-621(b) (2)).

Section 6.21 (§ 4-33-621) does not deal with the question of the substantive grounds for termination. Nor does it negate the requirements that the procedure be carried out in good faith and not conflict with the corporation's internal procedures.

To provide finality subsection (d) (§ 4-33-621(d)) requires that a proceeding challenging an expulsion, suspension or termination be commenced within one year after the date of the expulsion, suspension or termination.

A person who has been expelled or suspended is liable for dues, assessments and fees based on commitments made or obligations incurred prior to the expulsion or suspension. If the person has contracted or agreed to make payments to the corporation regardless of his or her status as a member, that obligation continues even though the person is suspended or is no longer a member. In general, courts have not evaluated the fairness and reasonableness of procedures used by religious corporations to expel or suspend members. Section 6.21 (§ 4-33-621) does not expand or contract the rights of members of religious corporations in regard to termination, expulsion or suspension.



**Official Comment to Section 6.22 (A.C.A. § 4-33-622)**

Section 6.22 (§ 4-33-622) distinguishes public benefit and religious corporations from mutual benefit corporations by prohibiting the former from purchasing any of their memberships.

The assets of public benefit and religious corporations are held for a public, charitable or religious purpose and may not be distributed to members upon dissolution or while the corporation is operating. Allowing public benefit and religious corporations to purchase memberships would invite evasion of this rule.

Members in mutual benefit corporations may have an economic interest in the corporation and their memberships may represent a valuable asset. Upon dissolution, any surplus may be distributed to members in the absence of some other distribution provision. Consequently, there is no need for an absolute

prohibition on purchase of memberships. In fact, there is a need to authorize such purchases under specified conditions. For example, country clubs and other mutual benefit organizations often issue memberships and agree to repurchase them if certain conditions are met.

Certain protections must be provided to the creditors of the corporation to ensure that the assets are not improperly diverted to members thereby rendering the corporation unable to meet its liabilities. Consequently, the provisions of Chapter 13 (§ 4-33-1301 et seq.) relating to prohibited distributions are specifically referenced in section 6.22 (§ 4-33-622).

If a mutual benefit corporation has members, a bylaw provision authorizing purchase of memberships must be approved by the members. See sections 10.21 and 10.22 (§§ 4-33-1021 and 4-33-1022).

**Official Comment to Section 6.30\*****1. Who May Bring Derivative Suits**

Section 6.30 authorizes any director or members of domestic or foreign corporations holding five percent or more of the voting power or fifty members, whichever is less, to bring a derivative suit on behalf of the corporation. Each complainant must be a member or director at the time of the proceeding, but does not have to have been a member or director at the time of the complained-of act. The five percent or fifty-member test and the discretion a court has to award expenses (including counsel fees) if it finds that the suit was commenced without reasonable cause, should prevent strike suits and suits by a single or insignificant number of members.

**2. Prior Demand on Board**

In most instances prior demand on a corporation's board is a condition precedent to bringing a derivative suit. The demand allows the directors to investigate the claim and to act on behalf of the corporation if they find that action is warranted. If the corporation's investigation is in progress when the proceeding is filed, the court has discretion to stay the suit until the investigation is completed.

In some instances it is not necessary to make a demand on the directors prior to bringing suit. Where a demand would be useless the person bringing the action

need only allege the reasons a demand was not made. A demand would be useless, for example, if the suit was against all the directors for entering into a conflict of interest transaction.

There is no requirement of a demand on a corporation's members.

Section 6.30 does not answer the vexing question of the effect of a determination by an independent majority of the board not to sue. This question is left to a case-by-case determination by the courts.

**3. Miscellaneous Procedural Matters**

Section 6.30 does not require those bringing a derivative suit to post a bond for expenses of the corporation or its officers or directors. On balance a bond requirement does more to deter meritorious suits by those unable to afford a bond, than to provide protection to the corporation and its officers.

**4. Termination of the Proceeding**

To ensure that settlement of a derivative suit is fair to the corporation and all its members, common law requires court approval of any settlement or discontinuance of the action. If a court determines that a proposed discontinuance or settlement will substantially affect the interests of a corporation's members, it may require notice of the settlement to be sent to the members. The court has discretion

to determine who is to pay for the cost of giving notice. If notice is required, a court should consider the possibility of giving notice by means of a corporate magazine or newsletter. See section 1.41 (§ 4-33-141).

#### **5. Award of Costs and Counsel Fees**

A court has discretion to require the complainants to pay the defendant's reasonable expenses (including counsel fees) if it finds that the proceeding was commenced frivolously or in bad faith. Section 8.30(d) (§ 4-33-830(d)). This provision is particularly important in the case of public benefit or religious corporations that may spend funds defending a lawsuit rather than devoting them to their public, charitable or religious purposes.

A court also has discretion to award reasonable expenses (including counsel fees) to complainants if: (1) they were successful in whole or in part (success requires that the corporation take some action that the complainants sought or receive some economic or other benefit); or (2) anything was received by the corporation as a result of a judgment.

If the complainants are members of a public benefit corporation they can not receive anything of economic value as a result of a derivative suit. Members of

mutual benefit or religious corporations may receive something of value so long as that which they receive is not a prohibited distribution.

#### **6. Notice to the Attorney General**

The attorney general must be given notice of any derivative suit involving a public benefit corporation or assets held in charitable trust by a mutual benefit corporation. The notice provides the attorney general an opportunity to learn of and evaluate the dispute. After an evaluation the attorney general may, but does not have to, join in any such action. See section 1.70 (not enacted by Arkansas).

#### **7. Exhaustion of Internal Remedies**

Some nonprofit corporations have procedures for resolving internal disputes. In general these procedures should be exhausted prior to bringing a derivative suit.

#### **8. Constitutional Limitations**

Federal or state constitutional provisions may prohibit courts from considering derivative suits brought on behalf of religious corporations.

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\*This section was not enacted by Arkansas.

### **Official Comment to Section 6.40 (A.C.A. § 4-33-640)**

Section 6.40 (§ 4-33-640) authorizes corporations to operate with delegates rather than or in addition to members or a self-perpetuating board. The law in regard to delegates and their rights is not as well developed as that relating to members or self-perpetuating boards. For this reason section 6.40 (§ 4-33-640) does not set forth detailed provisions. It authorizes the articles or bylaws to set forth rules in regard to delegates, meetings of delegates, and carrying on corporate activities during and between meetings of delegates.

Section 6.40 (§ 4-33-640) does not immunize these rules from attack, but creates a presumption of their validity. In

amending, deleting or adding rules, the corporation must comply with its own internal requirements.

Once rules have been adopted they must be applied in a reasonable way considering the nature, size, customs and operations of the corporation.

If the corporation has a board, the board is bound by the provisions set forth in Chapter 8 (§ 4-33-801 et seq.). Insofar as the delegates have been given the powers or some of the powers of members or the board, they have analogous rights, duties and obligations. See section 8.01 (§ 4-33-801).

### **Official Comment to Section 7.01 (A.C.A. § (§ 4-33-701))\***

Section 7.01(a) (§ 4-33-701(a)) requires all nonprofit corporations with members to hold annual meetings. The main activity at most annual meetings is the election

of directors. However, directors may be elected by written ballot or written consent. See sections 7.04 and 7.08 (§§ 4-33-704 and 4-33-708). Even if directors are



not to be elected, it is still necessary to have an annual meeting to: (1) serve as a town forum in which the president and officers report on and answer reasonable questions concerning the activities and financial condition of the corporation; and (2) consider matters that may be raised consistent with the requirements of sections 7.05 and 7.23(b) (§§ 4-33-705 and 4-33-723 (b)).

Some nonprofit corporations hold regular meetings of members in addition to holding an annual meeting of members. In some cases these regular meetings deal with matters that might otherwise be dealt with by the board of directors. Section 7.01(b) (§ 4-33-701(b)) recognizes this practice and allows nonprofit corporations to hold regular meetings of members at times stated in or fixed in accordance with their bylaws. The Model Act (§ 4-33-101 et seq.) does not require that any action be taken at these meetings. However, any action taken must be consistent with the notice requirements of sections 7.05 and 7.23(b) (§§ 4-33-705 and 4-33-723(b)).

If an annual or required regular meeting is not held, a member and, in the case of a public benefit corporation, the attorney general, may sue under section 7.03 (§ 4-33-703) to compel the corporation to hold the meeting.

Many nonprofit corporations operate informally and may not hold an annual or regular meeting required by their bylaws.

The failure to hold an annual or regular meeting: (1) "does not affect the validity of any corporate action" (section 7.01(d)) (§ 4-33-701(d)); and (2) the directors in office continue to serve until their successors are elected and qualify (section 8.05(b)) (§ 4-33-805(b)). The corporation can continue to function. Actions taken by its board, officers and employees will be valid even though the corporation has not complied with the requirements of section 7.01 (§ 4-33-701). However, the directors' failure to call an annual or regular meeting might violate the duties set forth in section 8.30 (§ 4-33-830).

The bylaws may state the time and place of annual and regular meetings or may authorize the board or some other person to determine the time and place of annual and regular meetings. If the latter approach is used, the board or person calling the meeting has great discretion in establishing a convenient time and place for the meeting. This discretion must be exercised in good faith consistent with the duties set forth in section 8.30 (§ 4-33-830).

Annual meetings are only required for corporations with members. If a corporation has no members, there is no purpose in mandating an annual meeting of members.

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\*The version of this section enacted by Arkansas differs from the Model Act.

## Official Comment to Section 7.02 (A.C.A. § 4-33-702)

### ***1. Matters To Be Considered at Special Meeting***

Special meetings are called to consider matters that have arisen between annual meetings. Only those matters that are within the purpose or purposes described in the notice of the special meeting may be considered at a special meeting. Section 7.02(e) (§ 4-33-702(e)). This is to ensure that members will have adequate notice of all matters to be considered, can decide whether or not to attend the meeting, and cannot be forced to vote on unnoticed matters.

### ***2. Persons Who May Call Special Meetings***

Special meetings of all nonprofit corporations may be called by: (1) the board of directors; and (2) a person or persons

authorized to do so by the articles or bylaws. The articles or bylaws may authorize the presiding officer of the board, the president, any corporate officer, a member or any other person to call a special meeting of members. Except as provided in the articles or bylaws of a religious corporation a person or persons holding five percent or more of the voting power of any corporation may demand that a special meeting be called.

### ***3. Obligations of Corporation***

The corporation has thirty days from receipt of a proper demand for a special meeting to give notice of the meeting. It has discretion to set a convenient time and place for the meeting, but should give due consideration to the time and place suggested by the person demanding a spe-

cial meeting. The board or person acting on behalf of the corporation must act in good faith consistent with the duties set forth in section 8.30 (§ 4-33-830).

#### **4. *Wrongful Refusal to Call Special Meeting***

In a nonprofit corporation, unlike a business corporation, those seeking a special meeting may have no economic ability or incentive to bring a legal proceeding to compel a special meeting. Requiring those seeking a special meeting to sue may be tantamount to prohibiting special meetings wrongfully opposed by those running the corporation. Consequently section 7.02(c) (§ 4-33-702(c)) allows those seeking a special meeting to resort to self-help if the corporation has wrongfully refused to call a meeting for a thirty-day period. Those seeking the meeting are authorized to call the meeting at a convenient time and place. In setting the time and place they must act reasonably and in good faith. The self-help remedy will be available only if the members seeking the

meeting have a membership list or access to a membership list. The provisions of section 7.20 (§ 4-33-720) and Chapter 16\*\* allow access to a membership list to communicate with other members concerning a special meeting. However, a corporation that wrongfully refuses to call a special meeting is not likely to voluntarily supply a membership list. Therefore, as a practical matter the self-help remedy is limited to corporations with a few members or those where the membership list is generally available.

If the members cannot or do not want to notice a meeting, they may sue under section 7.03 (§ 4-33-703)\* to compel the corporation to notice and hold the meeting.

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\*Chapter 16 of the Model Act was not enacted by Arkansas.

\*\*The version of section 7.03 enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 7.03 (A.C.A. § 4-33-703)\***

Section 7.03 (§ 4-33-703) allows members, persons entitled to participate in an annual or regular meeting or to call a special meeting, and the attorney general in the case of a public benefit corporation, to have a court enforce the provisions of sections 7.01 and 7.02 (§§ 4-33-701 and 4-33-702) requiring annual, regular and special meetings. The court may act if (1) the annual meeting has not been held within the earlier of six months after the end of the corporation's fiscal year or fifteen months after its last annual meeting; (2) the regular meeting has not been held within 40 days after the date it was required to be held; or (3) a special meeting is not noticed within thirty days after the date demand was delivered to a corporate officer or was not held within a reasonable time. See section 7.05 (§ 4-33-705).

Under section 7.03 (§ 4-33-703) a court has discretion to determine whether or not to call an annual, regular or special meeting, when and where it should be held, what the record date will be, and

what conditions, if any, should be imposed as a condition to holding the meeting. If it orders a meeting, it also has discretion to determine whether or not attorney's fees and costs should be paid by the corporation. In exercising its discretion the court should consider the good faith of the parties, the reasons the meeting has not been noticed or held, and other relevant factors.

Subsection (b) (§ 4-33-703(b)) allows the court to fix the quorum requirement "or direct that the votes represented at the meeting constitute a quorum for" specified matters. This second alternative prevents those opposing the meeting from not attending the meeting or withholding sufficient proxies to prevent a meeting from occurring due to lack of a quorum. A court-ordered notice should set forth any special quorum requirements to prevent members from being misled.

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\*The version of this section enacted by Arkansas differs from the Model Act.



**Official Comment to Section 7.04 (A.C.A. § 4-33-704)**

Section 7.04 (§ 4-33-704) authorizes members holding at least eighty percent of the voting power acting by written consent to take any action that could be taken at a meeting of members. See section 1.40(35) (§ 4-33-140(36)) for a definition of voting power. Mergers, sale of all or substantially all of a corporation's assets, dissolution and other significant corporate actions can be approved by written consent. The articles or bylaws may limit or prohibit action by written consent.

Subsection (d) (§ 4-33-704(d)) requires that each member who did not sign the written consent be given written notice of any action approved pursuant to section 7.04 (§ 4-33-704). Action authorized pursuant to section 7.04 (§ 4-33-704) is effective ten days after such notice is given. See section 1.41 (§ 4-33-141) for a definition of the effective date of the notice. This notice provides an opportunity for members to protect their rights.

Corporations with numerous members can usually hold a meeting quicker than they can take action pursuant to section 7.04 (§ 4-33-704). Consequently section 7.04 (§ 4-33-704) will only be useful to

nonprofit corporations with a few members or with a few members who hold at least eighty percent of the voting power.

A member may withdraw his or her consent at any time prior to consents representing eighty percent of the voting power being delivered to the corporation. Any such withdrawal is ineffective if delivered after the requisite consents have been delivered to the corporation. The withdrawing member may bring some court action to annul the consent if it was procured by fraud or some other improper means.

Action by written consent cannot serve as a substitute for a special meeting. If a special meeting is properly demanded, it must be held even though the matter or matters to be considered at the meeting could be voted upon by written consent. Similarly the annual meeting requirement of the Model Act (§ 4-33-101 et seq.) may not be circumvented by having a written consent. Even if directors are elected by written consent, the annual meeting must be held as provided in section 7.01 (§ 4-33-701).

**Official Comment to Section 7.05 (A.C.A. § 4-33-705)**

Section 7.05 (§ 4-33-705) provides alternative ways of complying with the notice requirements of the Model Act (§ 4-33-101 et seq.). A nonprofit corporation may comply with the "safe harbor" notice requirements contained in subsection (c) (§ 4-33-705(c)) or for some matters it may given notice by any means consistent with its bylaws that is "fair and reasonable when all the circumstances are considered." The circumstances include the purpose of the meeting and the nature, size, customs, and operations of the corporation. Section 7.05(b) (§ 4-33-705(b)).

The "safe harbor" provisions require notice of the place, date and time of each annual and special meeting of members. This notice must be given no fewer than 10 nor more than 50 days before the meeting date unless the notice is mailed by other than first class or registered mail. To save money, many nonprofit corporations use their nonprofit mailing privileges to send notices. To accommodate this practice, section 7.05(c) (1) (§ 4-33-705(c) (1)) authorizes mailing by other

than first class or certified mail but requires that notice sent by such means be mailed at least 30 days before the meeting date.

The "safe harbor" provisions distinguish between annual, regular and special meetings in one respect. Notice of special meetings must include a description of the matter or matters that will be considered at the meeting. The notice of annual and regular meetings does not require a description of any matters to be considered at the meetings unless there is a proposal to amend the articles or bylaws, to indemnify a director or to approve a merger, sale of assets, dissolution or conflict of interest transaction.

While the "safe harbor" provisions are similar to typical notice requirements for business corporations, they may not be consistent with the practice of small, non-traditional or financially insignificant nonprofit corporations. Therefore, section 7.05(b) (§ 4-33-705(b)) provides that except for approval of conflict of interest transactions, indemnification, amend-

ment of articles and bylaws and approval of mergers, sale of assets and dissolution, "other means of giving notice may also be fair and reasonable when all the circumstances are considered." Posting notice of a meeting on a bulletin board, an oral announcement at a meeting of members or some other means of providing notice may be sufficient.

In determining whether notice is fair and reasonable past practice is of great significance but is not necessarily controlling. The fact that a corporation has traditionally given notice in a particular way is strong evidence that it is fair and reasonable. To be fair and reasonable, notice must follow provisions set forth in a corporation's bylaws.

Numerous other matters including the following may be important in determining whether notice was given in a fair and reasonable manner: the cost of complying with the "safe harbor" provisions relative to the assets of the corporation, the diffi-

culty in complying with the "safe harbor" provisions, the good faith of those giving the notice, the importance and uniqueness of the matter voted upon, the sophistication and expectations of the members and the historical attitude of the members toward notice of meetings.

Section 1.41 (§ 4-33-141) sets forth various ways in which notice can be given. Subsection (f) of section 1.41 (§ 4-33-141(f)) may be particularly helpful to nonprofit corporations. It allows a "notice ... mailed or delivered as part of a newsletter, magazine or other publication regularly sent to members to constitute written notice...."

Section 7.22 (§ 4-33-722) should be considered when giving notice of annual, regular and special meetings because the quorum requirements of section 7.22 (§ 4-33-722) vary depending on the type of notice provided and the number of members attending the meeting in person or by proxy.

### Official Comment to Section 7.06 (A.C.A. § 4-33-706)

#### 1. *Written Waiver*

A member may waive any notice requirement imposed by the Model Act (§ 4-33-101 et seq.) or a corporation's articles or bylaws by signing and delivering a written waiver of notice to the corporation. The waiver may be signed and delivered either before or after the meeting or other event the notice of which is being waived. It may be a general waiver of all matters considered at a meeting or a limited waiver of specified actions.

#### 2. *Waiver by Attending Meeting*

A member waives defective notice or failure to give notice of the date, time and place of a meeting by appearing at the meeting without raising an objection at the beginning of the meeting. If a member objects at the beginning of the meeting, the member preserves the right to object to the defective notice or lack of notice.

"Defects waived by attendance ... include a failure to send the notice altogether, delivery to the wrong address, a misstatement of the date, time or place of the meeting, and a failure to notice the meeting within the time periods specified in section 7.05.... For purposes of this section, 'attendance' at a meeting involves the presence of the [member] in person or by proxy." Official Comment to Section

7.06 of the Model Business Corporation Act (§ 4-27-706).

To meet the "safe harbor" provisions of section 7.05(c) (§ 4-33-705(c)), each matter to be considered at special meetings and certain matters to be considered at annual and regular meetings must be set forth in the notice of the meeting. A member who attends a meeting would not necessarily know that these matters would be considered unless the member received proper notice. Mere attendance at a meeting should not, and under the Model Act (§ 4-33-101 et seq.), does not, waive a member's right to object to consideration of matters not properly noticed. A member may object to considering improperly noticed matters when they are presented. A member who does not object to consideration of such matters when they are presented, waives the right to object.

In some instances the waiver procedures of the Model Act (§ 4-33-101 et seq.) may be unfair to a nonaggressive or unsophisticated member who learns of a meeting just before it commences or walks into a meeting while it is in progress without knowing what is occurring. On balance, however, the waiver provisions provide certainty to the corporation and prevent



members from appearing, losing a vote, and subsequently raising an objection to a lack of notice in a legal proceeding.

### Official Comment to Section 7.07 (A.C.A. § 4-33-707)

The concept of a record date is foreign to many nonprofit corporations. Nonprofit corporations often allow people to vote who become members on the day of a meeting. Some corporations use the right to vote as an incentive to join. These corporations have a cutoff day in advance of the meeting to determine who will receive notice of the meeting, but allow members who subsequently join to vote. Other nonprofit corporations, typically large or sophisticated organizations, adopt the record date concept used by business corporations. These corporations use the same record date to determine those entitled to notice and vote at a meeting. To accommodate these diverse practices the Model Act (§ 4-33-101 et seq.) separates the concept of record date for notice from record date for the right to vote.

If the bylaws do not fix or provide the manner for fixing a record date for notice of a meeting, the board may do so. If no provision is contained in the bylaws and the board does not act, "members at the close of business on the business day preceding the day on which notice is given ... are entitled to notice of the meeting." Section 7.07(a) (§ 4-33-707(a)). If a meeting is held without notice and notice is waived, the day for determining who is entitled to waive notice is "the close of business on the business day preceding the day on which the meeting is held." Section 7.07(a) (§ 4-33-707(a)).

If the bylaws do not fix or provide a manner for fixing a record date for voting at a meeting, the board may do so. If no

provision is contained in the bylaws and the directors do not act, "members on the date of the meeting who are otherwise eligible to vote are entitled to vote at the meeting." Section 7.07(b) (§ 4-33-707(b)).

If the bylaws do not fix or provide the manner for determining the record date for exercising rights other than the right to notice or to vote at a meeting, the board may do so. For example, the directors may set a record date for determining members of a mutual benefit corporation entitled to a distribution on dissolution of the corporation. If the bylaws do not set such a record date and the directors do not act, then the record date is the day on which the board adopts the resolution authorizing the distribution or the 60th day prior to the distribution, whichever is later.

These results comport with the way most nonprofit organizations operate. Corporations that operate in a different manner may adopt a bylaw or a corporate resolution setting forth a different record date.

A record date for determining what members are entitled to notice or vote at a meeting of members may be effective for an adjourned meeting provided the adjourned meeting is no more than 70 days after the record date for determining members entitled to notice of the original meeting. The board may always fix a new date for determining members entitled to notice or vote at an adjourned meeting provided it does so in good faith in a manner consistent with its obligations under section 8.30 (§ 4-33-830).

### Official Comment to Section 7.08 (A.C.A. § 4-33-708)

Section 7.08 (§ 4-33-708) authorizes election of directors and approval of actions by written ballot. The ballots must be distributed to every member, provide specified information and allow a reasonable time for their return.

Most nonprofit corporations do not have sophisticated means of counting ballots. To ease the problem of counting ballots subsection (e) (§ 4-33-708(e)) provides

that a written ballot cannot be revoked unless revocation is authorized by the articles or bylaws.

Section 7.08 (§ 4-33-708) does not prohibit cumulative voting when directors are being elected by written ballot. However, the board of a corporation should think twice before allowing cumulative voting by written ballot. If election is by written ballot, contesting factions cannot

sensibly decide how to allocate their votes to maximize the number of directors they can elect.

Action by written ballot may not serve as a substitute for an annual or special meeting of members.

### **Official Comment to Section 7.20 (A.C.A. § 4-33-720)\***

#### **1. Rights Provided to Members**

A corporation is required to make its membership list available to any member for inspection or copying two days after notice of the meeting is given. The list must include the name and address and number of votes each member is entitled to cast at the meeting and must be updated to and including the date of the meeting. The need to update the list would only occur if members entitled to vote at the meeting join the corporation after the notice of the meeting is given. See section 7.07 (§ 4-33-707).

Prior to the meeting the list must be available at the corporation's "principal office" or "at a reasonable place identified in the meeting notice in the city where the meeting is to be held." In addition the list must be available at the meeting of members. Prior to and during the meeting of members the list may be copied at the member's expense by the member or the member's agent or attorney.

The right to inspect a copy of the list pursuant to section 7.20 (§ 4-33-720) is separate and independent of the inspection rights contained in Chapter 16.\*\* However, the limitations on inspection and copying rights of sections 16.02(c) and 16.05\*\*\* are applicable to inspection and copying under section 7.20 (§ 4-33-720).

If a record date notice of a meeting is less than two days prior to the meeting because the meeting will be held pursuant to written waivers of notice, the list need only be available for inspection and copying at the meeting.

#### **2. Enforcement of Rights**

A court may summarily order inspection and copying of the list at the corporation's expense. In addition it may postpone the meeting for such period of time as it deems reasonable if the list has been wrongfully withheld and may order the corporation to pay the reasonable costs

including counsel fees incurred to obtain the orders it makes. The court is not required to make any order, but has broad discretion to do what is appropriate and necessary under the circumstances taking into consideration the good faith of the parties, the reasons the corporation refused to provide the list, and other relevant facts.

#### **3. Effect of Refusal to Comply with Section (§ 4-33-720)**

With one exception the validity of any action taken at a meeting is not affected by the refusal or failure of the corporation to prepare, identify the location, or make available the list of members. In most instances members will not even ask to look at the membership list. In such cases the failure to follow the requirements of section 7.20 (§ 4-33-720) are of no consequence. Where a corporation wrongfully refuses a member's request prior to a meeting to inspect a membership list, a court may invalidate the meeting after consideration of all the equities. If an action is brought prior to the meeting, a court may postpone the meeting until the member has had a reasonable opportunity to copy and use the membership list.

#### **4. Religious Corporations**

The rights of inspection set forth in section 7.20 (§ 4-33-720) may be limited or abolished in a religious corporation's articles or bylaws. If they are not limited or abolished, members of religious corporations have the rights set forth in section 7.20 (§ 4-33-720).

\*The version of this section enacted by Arkansas differs from the Model Act.

\*\*Chapter 16 of the Model Act was not enacted by Arkansas.

\*\*\*Sections 16.02(c) and 16.05 were not enacted by Arkansas.

### **Official Comment to Section 7.21 (A.C.A. § 4-33-721)\***

Section 7.21 (§ 4-33-721) sets forth the basic rule that each member is entitled to

one vote on each matter voted on by the members unless the articles or bylaws



provide otherwise. Also see section 6.10 (§ 4-33-610). Corporations that wish to provide different voting rights may do so in their articles or bylaws. Different voting rights can be based upon the amount of dues paid or contributions made, the number of hours devoted to the corporation's activities, the net worth, sales volume, or number of outlets of a corporate member or innumerable other factors considered significant by the organization. These distinctions will be upheld by the courts unless they violate some federal or state law or are adopted in violation of some provision of the Model Act (§ 4-33-101 et seq.).

Subsection (b) (§ 4-33-721(b)) deals with single memberships held by two or

more persons. In the absence of a contrary bylaw provision, if only one person votes, that vote binds the other holders. If more than one person votes, the vote is split pro rata based on the number of people voting. This rule comports with normal expectations, at least where one membership is held by a family and each member of the family is listed as holding part of the membership. In a mutual benefit organization where a membership is valuable, this rule may not make sense and some alternate approach should be set forth in the bylaws.

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\*The version of this section enacted by Arkansas differs from the Model Act.

### Official Comment to Section 7.22 (A.C.A. § 4-33-722)

Many nonprofit corporations have a low member turnout and need a low quorum to hold annual, regular or special meetings. In recognition of this need the section (§ 4-33-722) does not set a lower limit on a quorum requirement. For example, the bylaws may provide that the quorum is composed of those attending the meeting or those voting upon a matter. This insures a quorum so long as one member attended the meeting or voted on a matter.

With the low quorum requirement authorized by section 7.22 (§ 4-33-722) a few members may plan to take over an annual or regular meeting and vote upon matters that were not noticed. To protect against this possibility section 7.22(d) (§ 4-33-722(d)) prohibits members from voting upon a matter that was not noticed unless one third or more of the voting power is represented. When, however, a matter is noticed, a quorum of one member can act upon it. If the matter is not noticed, at least one third of the voting power must be present to take action. At special meetings members may only vote on matters that are noticed. See section 7.02(e) (§ 4-33-702(e)).

Section 7.22(b) (§ 4-33-722(b)) allows the members or the board to decrease the quorum. Decreasing the quorum should

not be detrimental to the members as member action still requires at least approval by a majority of a quorum. The notice requirements of section 7.05 (§ 4-33-705) and voting requirements of section 7.23(a) (§ 4-33-723(a)) provide additional protection. The bylaws may provide complete protection, and rigidity, by prohibiting the board from decreasing the quorum.

A bylaw amendment to increase the quorum may make it difficult for members to act. Consequently section 7.22(c) (§ 4-33-722(c)) requires any such amendment to be approved by the members.

For those corporations whose articles or bylaws do not set a quorum, subsection (a) (§ 4-33-722(a)) provides that the quorum shall be ten percent of the votes entitled to be cast on the matter. See section 1.40(35) (§ 4-33-140(36)) for a definition of "voting power."

Quorum requirements may be changed by complying with the provisions of sections 10.01 through 10.05 (§§ 4-33-1001 — 4-33-1005) when amending articles and sections 7.23 and 10.20 through 10.23 (§§ 4-33-723 and 4-33-1020 — 4-33-1023) when amending bylaws. Section 10.30 (§ 4-33-1030) may require the consent of a third person when the articles or bylaws are amended.

**Official Comment to Section 7.23 (A.C.A. § 4-33-723)**

See section 1.40(1) (§ 4-33-140(1)) for the definition of “approved by the members.” Also see the Official Comment to section 1.40 (§ 4-33-140) for a discussion of the meaning of “approved by the members.” The question of the member vote required to approve an action should be within the control of the members. Consequently section 7.23(c) (§ 4-33-723(c)) re-

quires member approval to amend the bylaws to increase or decrease a required vote. Of course, the members can not reduce the vote required for member action below a majority of the required quorum. Section 1.40(1) (§ 4-33-140(1)). Nor may they change a vote mandated by the Model Act (§ 4-33-101 et seq.).

**Official Comment to Section 7.24 (A.C.A. § 4-33-724)**

Section 7.24 (§ 4-33-724) authorizes members to vote by proxy, but allows the articles or bylaws to prohibit or limit proxy voting.

“The word ‘proxy’ is often used ambiguously, sometimes referring to the grant of authority to vote, sometimes to the document granting the authority, and sometimes to the person to whom the authority is granted ... the word ‘proxy’ is used only in the last sense; the term ‘appointment form’ is used to describe the document appointing the proxy; and the word ‘appointment’ is used to describe the grant of authority to vote.” Official Comment to Section 7.22 of the Model Business Corporation Act (§ 4-27-722).

A member or the member’s attorney-in-fact may appoint a proxy by signing an appointment form. No particular type of form is required. A proxy may vote or otherwise act for the member on all matters unless the appointment form contains an express limitation on the proxy’s authority. Members wishing to limit the

power of a proxy should carefully draft the authorization form to limit the proxy’s power.

The corporation must treat the act of the proxy as the act of the member unless the appointment form limits the power of the proxy or directs the proxy to act in a specified way. Any such limitation or direction must be observed by the corporation.

The appointment of a proxy may be revoked at any time. See subsection (e) (§ 4-33-724(e)) for means of revocation.

To provide certainty, subsection (d) (§ 4-33-724(d)) modifies common law principles and allows a corporation to accept a proxy’s authority until it receives notice of the death or incapacity of the member appointing the proxy. A proxy’s vote or other action is final and binding, but the proxy may be liable to the appointing member for damage resulting from the proxy’s failure to act in accordance with the appointment.

**Official Comment to Section 7.25 (A.C.A. § 4-33-725)**

Section 7.25 (§ 4-33-725) allows the articles or bylaws to authorize cumulative voting. As a condition to cumulative voting subsection (b) (§ 4-33-725(b)) requires that the meeting notice or proxy statement state that cumulative voting will take place or that during the meeting a member gives notice of the member’s intent to cumulate votes before the vote is taken. These requirements are imposed as cumulative voting should only be allowed if members know or reasonably should know that the election will be by cumulative voting. Otherwise unfair and unintended results will occur as some mem-

bers will cumulate their votes and others will not.

Section 7.25 (§ 4-33-725) also sets forth the mechanics of cumulative voting and protects a minority that has elected a director from having that director removed by the majority.

Subsection (c) (§ 4-33-725(c)) provides this protection by prohibiting the removal of a director if those opposing the removal would have been able to elect the director by cumulative voting.

Subsection (d) (§ 4-33-725(d)) prevents potentially unintended and unfortunate results by prohibiting cumulative voting



when the directors and members are identical. In such situations directors could perpetuate themselves in office by voting cumulatively. If self-perpetuation is de-

sired, it should be done directly by designation of directors or by some other means, not inadvertently by allowing cumulative voting.

### **Official Comment to Section 7.26 (A.C.A. § 4-33-726)**

As there is no valid reason to limit voting for directors to cumulative or straight voting, section 7.26 (§ 4-33-726) allows directors to be elected by three other specified methods and any other reasonable basis. The method of electing directors may not, however, be made up on

an ad hoc basis, but must be set forth in or authorized by the articles or bylaws. The board in overseeing an election must comply with the fiduciary standards set forth in section 8.30 (§ 4-33-830) regardless of the manner in which the election is conducted.

### **Official Comment to Section 7.27 (A.C.A. § 4-33-727)**

Section 7.27 (§ 4-33-727) sets forth the rules under which corporations may accept the signature on a vote, consent, waiver, or proxy appointment as that of a member or of someone authorized to act on behalf of the member. Section 7.27 (§ 4-33-727) is designed to provide certainty and protect nonprofit corporations and their officers and agents who act in good faith in reliance on its rules. It therefore provides that corporations are entitled to reject a vote, consent, waiver, or proxy appointment if the person authorized to tabulate votes in good faith has reasonable basis for doubt about the validity of the signature or the signatory's authority to sign for the member. Even if the vote is in fact authorized, the corporation and its agents will not be liable. Similarly if a vote, consent, waiver, or proxy appointment is improperly accepted or rejected, there will be no liability to the corporation or its agent if the person making the decision acted in good faith in accordance with the standards of the section.

"The phrase 'reasonable basis for doubt' about the validity of a signature or about the signer's authority creates an objective standard for the exercise of the authority ... to reject proffered instruments. In the absence of a proxy fight or a seriously contested issue, instruments should be rejected only if there seems to be no basis for finding the execution regular on its face. In a proxy fight or other contested issue, the possibility of illegal or unauthorized execution is greatly increased, and a more cautious attitude should therefore be adopted." Official Comment to Section 7.24 of the Model Business Corporation Act (§ 4-27-724).

In most instances instruments purporting to be executed by or on behalf of members will in fact have been executed by and on behalf of the member "and the corporation and its officers should be encouraged to accept them rather than to adopt unduly narrow requirements." Official Comment to Section 7.24 of the Model Business Corporation Act (§ 4-27-724).

### **Official Comment to Section 7.30 (A.C.A. § 4-33-730)**

Section 7.30 (§ 4-33-730) validates a written voting agreement signed by two or more members. For public benefit and religious corporations the agreement must be for a proper purpose not inconsis-

tent with the corporation's purposes. Courts should take into account all relevant facts in determining whether an agreement has a proper purpose.

### **Official Comment to Section 8.01 (A.C.A. § 4-33-801)**

The Model Act (§ 4-33-101 et seq.) allows considerable flexibility in structuring

nonprofit corporations. While every corporation must have a board of directors, the

articles may authorize a person or persons to exercise some or all of the powers of the board.

Insofar as the powers of the board are delegated to some other person or persons, that person or persons assume the duties of the board and must meet the standards set forth in sections 8.30—8.33 (§§ 4-33-830 — 4-33-833). If the board had no corporate power it would have no duties under sections 8.30—8.33 (§§ 4-33-830 — 4-33-833).

In some organization corporate authority is exercised by a representative assembly or a convention. The board may have little or no corporate power when the assembly or convention is meeting. Corporate power between assemblies or conventions may reside in a board of directors or some other person or persons. The person or persons under whose authority corporate power is exercised has the responsibilities of the board of directors.

The role played by the boards of nonprofit corporations varies widely due to the nature, size, characteristics and needs of the organizations. Absent a contrary article provision “[a]ll corporate powers shall be exercised by or under the authority of” the board.

In some nonprofit organizations the board is actively involved in the day-to-

day activities of the corporation. Board members may carry on all or substantially all of the work of the corporation. In such instances the corporate powers are exercised by the board and the affairs actively managed under the direction of the board.

In other nonprofit corporations the board is significantly involved in fundraising or other activities and also validates or approves policy and other decisions made by the corporation’s officers and employees. In such instances the corporate powers are exercised under the authority of the board and the affairs are managed under the direction of the board.

In each of the above instances the board has the ultimate authority and responsibility. The authority is exercised and responsibility is carried out in different ways. Each director must meet the standards and is entitled to the protection afforded by sections 8.30—8.33 (§§ 4-33-830 — 4-33-833).

Boards of nonprofit corporations are sometimes called boards of trustees, regents, overseers, or by some other name. Section 8.01 (§ 4-33-801) applies to the person or group under whose authority corporate powers are exercised and under whose direction the affairs of the corporation are managed, regardless of the name of the person or group.

### **Official Comment to Section 8.02 (A.C.A. § 4-33-802)**

Only individuals may serve as directors of nonprofit corporations. The Model Act (§ 4-33-101 et seq.) does not impose qualifications for directors. It does not require directors to be members of the corporation or residents of its state of incorporation. However, articles or bylaws may impose qualifications for election to or service on a board of directors. A corporation may require that each director be a member in good standing of the organization. For example, the Young Republicans may require each director to be under thirty-six and Republican.

An article or bylaw qualification existing at the time an individual is elected a director is valid unless it violates public policy or some law other than the Model Act (§ 4-33-101 et seq.). If a qualification adopted after the director’s term commences would disqualify a director, it cannot be enforced until after the end of the director’s term. The procedures for removing a director are set forth in sections 8.08—8.10 (§§ 4-33-808 — 4-33-810).

### **Official Comment to Section 8.03 (A.C.A. § 4-33-803)**

Section 8.03 (§ 4-33-803) requires nonprofit corporations to have a minimum of three directors, but otherwise allows the number of directors to be specified or fixed in accordance with the articles or bylaws. The articles or bylaws may allow the

board to set the number of directors without placing any limit on the maximum number of directors. Alternatively, the articles or bylaws may specify a fixed or maximum number of directors or a range within which the board or the members



may determine the number of directors.

The Model Act (§ 4-33-101 et seq.) does not limit the range within which the number of directors may be set. Where control is a factor, the articles or bylaws may appropriately limit the size of the board and the authority of the board to elect directors.

If the corporation has members, an amendment to the articles or bylaws

changing the authorized number of directors must be approved by the members. See sections 10.03 and 10.21 (§§ 4-33-1003 and 4-33-1021). If the corporation does not have members, an amendment must be approved by the board of directors. See sections 10.02(b) and 10.20 (§§ 4-33-1002(b) and 4-33-1020). In either case approval by a third person may be required. See section 10.30 (§ 4-33-1030).

### Official Comment to Section 8.04 (A.C.A. § 4-33-804)\*

#### 1. Corporations with Members

If a corporation has members, the members are entitled to elect all the directors in the absence of a contrary provision in the articles or bylaws. The articles or bylaws may set forth a simple one-vote-per-member structure or may provide for election by classes, chapters or other organizational units or by region or other geographic groupings. See sections 2.02 and 2.05 (§§ 4-33-202 and 4-33-205) as to appointment of initial directors. See sections 7.04, 7.08, 7.21, 7.25 and 7.26 (§§ 4-33-704, 4-33-708, 4-33-721, 4-33-725 and 4-33-726) as to the ways in which members may vote.

Section 8.04 (§ 4-33-804) should be applied in a manner consistent with the concept that an election procedure must be reasonable. See *Dozier v. Automobile Club of Michigan*, 69 Mich. App. 114 (1976); *Braude v. Havenner*, 38 Cal. App. 2d 526, 113 Cal. Rptr. 386 (1974); *Valle v. North Jersey Automobile Club*, 125 N.J. Super. 302, 310 A.2d 518 (1973). The Model Act (§ 4-33-101 et seq.) does not specify detailed procedures, but leaves the matter to developing case law.

Even if a corporation has members, the members need not elect all the directors. Some directors may hold office as a result of designation in the articles or bylaws or as a result of being appointed by some person or entity.

Designation occurs when the articles or bylaws name an individual as a director or designate the holder of some office or position as a director. For example, the President of Harvard, the Bishop of New

York, or the head of a union may become a director of a corporation pursuant to an article or bylaw provision designating the holder of their position as a director of the corporation. The individual would cease to be a director upon ceasing to hold the designated position.

The articles or bylaws may authorize any person, corporation or entity to appoint a director. A city may want to appoint some or all the directors of a non-profit corporation without becoming a member of the organization. It could do so by appointing rather than voting for the directors. A person who appoints but does not vote for directors is not a "member" as that term is used in the Model Act (§ 4-33-101 et seq.). See section 1.40(21) (§ 4-33-140(22)).

#### 2. Corporation without Members

Section 8.04 (§ 4-33-804) authorizes self-perpetuating boards of directors. If a corporation does not have members, the board elects directors in the absence of an article or bylaw provision setting forth some other approach. See sections 2.02 and 2.05 (§§ 4-33-202 and 4-33-205) as to appointment of initial directors. See sections 8.21 and 8.24 (§§ 4-33-821 and 4-33-824) as to methods by which the board may elect directors.

Section 8.04 (§ 4-33-804) also allows all or part of the board to be designated or appointed pursuant to article or bylaw provisions.

\*The version of this section enacted by Arkansas differs from the Model Act.

### Official Comment to Section 8.05 (A.C.A. § 4-33-805)\*

Section 8.05(a) (§ 4-33-805(a)) allows the initial directors and directors elected

by the members or the board to serve for up to five-year terms.

The members' right to vote is illusory unless it can have an impact on the board. In the case of self-perpetuating boards, five-year terms allow continuity and also provide a graceful way of removing directors who may otherwise think they have life tenure. See section 8.04(b) (§ 4-33-804(b)) which allows a self-perpetuating board to elect successor directors.

Designated or appointed directors may serve any term prescribed by the articles or bylaws. See section 8.09 (§ 4-33-809) for provisions governing removal of designated or appointed directors.

In the absence of a contrary article or bylaw provision, the term of directors is one year.

The term of a director filling a vacancy of a director elected by members expires at the next election of directors by members. This election may be at the annual meeting or by written ballot. See sections 7.01 and 7.08 (§§ 4-33-701 and 4-33-708). The members may elect the director filling

the vacancy for the remainder of the unexpired term.

The term of a director filling the vacancy of a designated or appointed director or filling a vacancy on a self-perpetuating board is for the unexpired term of the director being replaced. See section 8.05(c) (§ 4-33-805(c)). Section 8.11 (§ 4-33-811) sets forth the ways in which vacancies can be filled.

Section 8.05(a) (§ 4-33-805(a)) prevents chaos by continuing directors in office until their successors are elected, designated, or appointed, and qualify. Even if successor directors are not elected, or if elected do not qualify, continuity on the board will be provided as the incumbent directors continue until their successors take office.

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 8.06 (A.C.A. § 4-33-806)**

Nonprofit corporations need to attract and keep qualified directors and provide continuity and experience on their boards of directors. Sections 8.05 and 8.06 (§§ 4-33-805 and 4-33-806) address this need by allowing directors to serve staggered terms of up to five years and not imposing a limitation on their reelection.

When there is a fight for control of the corporation, staggered terms may frustrate those trying to oust an incumbent board. This is because not all of the directors will be up for election each year. Section 8.08 (§ 4-33-808) provides a safety valve by allowing the members to remove the entire board without cause.

### **Official Comment to Section 8.07 (A.C.A. § 4-33-807)**

A director may resign at any time by delivering written notice as set forth in section 8.07 (§ 4-33-807). The notice may be effective when delivered, unless it specifies a later effective date. Section 1.41 (§ 4-33-141) governs the effective date of a notice. In resigning, directors must meet their obligations under section 8.30 (§ 4-33-830).

Under appropriate circumstances a court may find that an oral resignation combined with acts or omissions evidencing an intent to resign results in an effective resignation.

If a director elected by the members resigns or ceases to serve as a director, the vacancy may be filled by the members or the directors.

### **Official Comment to Section 8.08 (A.C.A. § 4-33-808)\***

#### ***1. Removal of Directors Elected by Members***

The members are authorized to remove directors elected by them without cause. While cause is not required, the removal may only take place at a meeting and may not take place by written consent or writ-

ten ballot. A notice of the meeting must state that the purpose or one of the purposes is removal of the director. The Model Act (§ 4-33-101 et seq.) does not require a director to be removed for cause as the members who elected the director, rather than a court, should determine whether



the members wish to remove the director.

A director may only be removed if the number of votes cast to remove the director would be sufficient to elect the director at a meeting to elect directors. Normally this would require a majority of the votes cast at a meeting at which a quorum is present. If the articles or bylaws require a higher vote for election of a director, that higher vote is required to remove the director. If a director was elected by a class or some other grouping of members, the votes cast within that class or grouping to remove the director must also be sufficient to have elected the director at a meeting to elect directors.

If cumulative voting is authorized, even if a director was not elected by cumulative voting, the director may not be removed if there are sufficient votes cast against the director's removal to have elected the director under cumulative voting. In doing this calculation it should be assumed that those voting for and against removal are voting in the most efficient fashion possible for removal or retention.

In any vote to remove a director, the computation of whether the director is removed should be based on the number of directors of the same class elected at the time of the election of the director whose removal is being sought. For example, if there is a vote to remove director Ratner and Ratner was elected by cumulative voting with four other directors, then the number of votes necessary to prevent Ratner from being removed is equal to the number of votes necessary to elect Ratner in an election in which five directors are elected.

## **2. Removal of Directors Elected by the Board**

If a board of directors is self-perpetuating or if it elects some of but not all of its members, it may remove the directors it has elected without cause by a vote of two-thirds of the directors then in office. Of course, the directors in removing a fellow director must meet the duty of care

and duty of loyalty set forth in section 8.30 (§ 4-33-830). See section 8.22 (§ 4-33-822) for applicable notice requirements.

The articles or bylaws may impose a greater vote requirement to remove directors. Unanimity may be required to remove a director. Such a requirement would prevent a director from being removed by the board without his or her consent. Directors may be removed by a judicial proceeding under section 8.10 (§ 4-33-810).

## **3. Removal of Directors for Failing to Attend Meetings**

Some nonprofit corporations, particularly those with large boards of directors, may find that some of their directors fail to attend meetings on a regular basis. Section 8.08(i) (§ 4-33-808(i)) allows the articles or bylaws to authorize the board to remove any director for failing to attend a specified number of meetings. The exact number of meetings must be specified in the article or bylaws at the time the director commences serving the term during which he or she is removed as a director. An article or bylaw provision adopted during the term of a director has no effect on that director until the director commences a new term. Removal requires a vote of a majority of the directors in office.

## **4. Religious Corporations**

Religious corporations should not be bound by secular concepts regarding removal of directors, but should have flexibility in setting removal procedures. Subdivision (j) (§ 4-33-808(j)) allows the articles or bylaws of a religious corporation to limit the application of section 8.08 (§ 4-33-808) and provide alternative ways of removing directors or prohibiting their removal by members or the board. The provisions of section 8.08 (§ 4-33-808) apply to religious corporations unless the corporation's articles or bylaws set forth different procedures or rules.

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\*The version of this section enacted by Arkansas differs from the Model Act.

# **Official Comment to Section 8.09 (A.C.A. § 4-33-809)**

## **1. Removal of Designated Directors**

Designated directors hold office as a result of an article or bylaw provision designating them individually or in some

representative capacity to serve as directors. Members and directors may not vote to remove designated directors. They may only be removed if the article or bylaw

provision designating them is deleted or changed so that they are no longer designated directors. See Chapter 10A and B (§§ 4-33-1001 — 4-33-1008 and 4-33-1020 — 4-33-1022). Also see section 10.30 (§ 4-33-1030) which allows any specified person to prevent an amendment to the articles or bylaws.

Designated directors may be removed in a judicial proceeding pursuant to section 8.10 (§ 4-33-810).

## **2. Removal of Appointed Directors**

Any person authorized to appoint a director may remove that director without cause except as otherwise provided in the articles or bylaws. The articles or bylaws may limit or completely restrict the right

of the appointing person to remove the director. The approval of the appointing person may be required for an amendment to the articles or bylaws, thereby insuring that a limitation on such person's ability to remove a director will not be added to the articles or bylaws without consent of such person. See section 10.30 (§ 4-33-1030).

The appointing person may remove his or her appointee by giving written notice pursuant to the procedures set forth in section 8.09(b) (§ 4-33-809(b)).

Appointed directors may be removed in a judicial proceeding pursuant to section 8.10 (§ 4-33-810).

## **Official Comment to Section 8.10 (A.C.1. § 4-33-810)\***

Section 8.10 (§ 4-33-810) authorizes members holding 10 percent or more of the voting power of any class to sue to remove a director. The corporation must be made a party to the action. Members holding less than 10 percent of the voting power of a class may bring a derivative suit to remove a director by complying with the provisions of section 6.30.\*\*

Section 8.10 (§ 4-33-810) also sets forth the grounds for removing an elected, designated or appointed director. A court must find that the director engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion, or that a final judgment had been entered finding that the director has violated a duty set forth in sections 8.30—8.33 (§§ 4-33-830 — 4-33-833), or if section 8.13\*\*\* has been adopted, that its provisions have been violated. In each case the court also must find that removal is in the best interest of the corporation.

A court may specify a period during which the removed director may not serve on the board or may impose conditions to that person becoming a director. Alternatively the court may bar a person who has been removed as a director from ever serving on the board.

The attorney general must be given notice of any proceeding under section 8.10 (§ 4-33-810) seeking removal of a

director of a public benefit corporation. The attorney general may intervene in the proceeding. Section 1.70.\*\*\*\*

Section 8.10 (§ 4-33-810) allows removal of directors who have engaged in wrongful activity. Absent such wrongful conduct, it should not be used for internal policy disputes or as part of a fight for control.

Subsection (e) (§ 4-33-810(e)) allows the articles or bylaws of a religious corporation to prohibit a court from removing corporate directors. Moreover, while subsection (a) (§ 4-33-810(a)) authorizes the attorney general to bring an action to remove a director of a public benefit corporation, no such authorization is set forth in regard to mutual benefit or religious corporations. This is because the attorney general has broad oversight powers over public benefit corporations, but a much more limited role in regard to mutual benefit and religious corporations.

\*The version of this section enacted by Arkansas differs from the Model Act.

\*\*Section 6.30 was not enacted by Arkansas.

\*\*\*Section 8.13 was not enacted by Arkansas.

\*\*\*\*Section 1.70 was not enacted by Arkansas.



**Official Comment to Section 8.11 (A.C.A. § 4-33-811)**

Section 8.11 (§ 4-33-811) sets forth the procedures for filling vacancies of elected, designated, or appointed directors and vacancies resulting from an increase in the authorized number of directors.

If a director elected by the members ceases to be a director, the vacancy may be filled by the members or the board in the absence of a contrary article or bylaw provision. Similarly vacancies arising when directors named in the original articles cease to be directors and vacancies resulting from an increase in the number of directors may be filled by the members or the board in the absence of a contrary article or bylaw provision.

Where, however, a vacancy occurs in an office held by an appointed director, only the person who appointed the director may fill the vacancy in the absence of an article or bylaw provision providing some other method of filling the vacancy. The underlying assumption is that the person who appoints the director should have the authority to pick the director's successor unless some other approach was considered and set forth in the articles or bylaws.

If the holder of a particular office is designated as a director of a nonprofit corporation and that person dies or resigns from office, a vacancy is created. In the absence of a contrary article or bylaw provision, the person who succeeds to that

office automatically becomes a director of the nonprofit corporation. For example, assume the dean of each law school in Texas is designated as a director of the Texas Law School Association and one dean resigns. The successor dean would automatically become a director of the Texas Law School Association.

Similarly, assume the executive director of a nonprofit corporation is designated as a director of the corporation. That person ceases being a director if he or she is fired as executive director. The new executive director automatically becomes a director of the corporation.

If the sole remaining director or directors constitute less than a quorum, section 8.11(a) (3) (§ 4-33-811(a) (3)) allows the remaining director or directors to fill the vacancy if the board is authorized to fill the vacancy. Assume a corporation has a board of eleven directors and the quorum is six. If five directors resign, section 8.11(a) (3) (§ 4-33-811(a) (3)) is not applicable as the directors remaining in office do not constitute less than a quorum. Four of the remaining six directors cannot fill the vacancies at a "meeting" attended by less than six directors. If six directors had resigned, section 8.11(a) (3) (§ 4-33-811(a) (3)) would apply and three directors, being a majority of the five directors then in office, would be able to fill the vacancies.

**Official Comment to Section 8.12 (A.C.A. § 4-33-812)**

Section 8.12 (§ 4-33-812) is intended to overrule the common law doctrine that prohibits directors from setting their own compensation.

Most nonprofit corporations do not compensate individuals for serving as directors. In some nonprofit corporations compensation may be appropriate as a result of the time and effort needed to serve as a director, the responsibilities undertaken, the ability of the corporation to pay and other relevant factors. Section 8.11 (§ 4-

33-811) allows the board to set directors' compensation for serving as directors. As a result of its power under section 8.01 (§ 4-33-801), the board also has the power to set the compensation of directors for serving as officers or in some other capacity. Section 8.12 (§ 4-33-812) does not authorize unreasonable levels of compensation. In setting directors' and officers' compensation, the board must comply with the standards contained in sections 8.30 — 8.33 (§§ 4-33-830 — 4-33-833).

**Official Comment to Section 8.13\***

The object of this optional section is to ensure that a majority of the directors of public benefit corporations do not have a built-in conflict of interest. Directors who

receive compensation from a corporation constantly make decisions that directly or indirectly affect their compensation. Thus they are not completely free to decide

dispassionately how to allocate a corporation's resources and what is in the corporation's best interest.

Section 8.13 addresses this problem. It requires that a majority of a public benefit corporation's directors and their close relatives not have received or be entitled to receive compensation from the corporation for services rendered to it during the prior twelve months. Reasonable payments for serving as a director are not considered compensation for purposes of section 8.13.

People who contribute to a public benefit corporation have the right to expect that its directors will manage its assets fairly and impartially to maximize its public or charitable purposes. People who work for and whose livelihood depend upon a public benefit corporation have an added pressure when deciding how to allocate its resources. They may also be invaluable members of the board due to their knowledge or expertise. Section 8.13 does not prevent them from serving on the board. It only requires that they comprise a minority of the directors.

Section 8.13 does not apply to situations in which an individual or individuals have contributed all or substantially all of the assets of a public benefit corporation and

simply serve on its board. Such individuals, in the absence of receiving the type of compensation that would make them interested persons, may comprise 100% of the board of the corporation.

Failure to comply with the provisions of section 8.13 does not affect the validity or enforceability of any transaction entered into by a corporation. Remedies for breach of section 8.13 are left to the courts for a case-by-case determination. The most likely remedy would be removal of the offending director or directors in a judicial proceeding under section 8.10 (§ 4-33-810).

The section is optional as many members of the Subcommittee on the Model Nonprofit Corporation Act felt that its provisions would be ineffective in preventing intentional abuses, while presenting a burdensome or inconvenient requirement. Intentional wrongdoers would simply ignore its provisions. Legitimate public benefit corporations might have difficulty in finding active and competent directors who had no financial interest in the corporation.

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\*This section was not enacted by Arkansas.

### **Official Comment to Section 8.20 (A.C.A. § 4-33-820)**

Unless the articles or bylaws provide otherwise, section 8.20 (§ 4-33-820) authorizes a board meeting to be conducted by any means of communication pursuant to which all participating directors may

simultaneously hear each other even though no two directors are present at the same location and the meeting does not take place in any specific location.

### **Official Comment to Section 8.21 (A.C.A. § 4-33-821)\***

Unless the articles or bylaws provide otherwise, section 8.21 (§ 4-33-821) allows a board of directors to take action by unanimous written consent. It allows the board to act quickly when there is a need to do so. Nonprofit corporations can act with the written consent of all the directors whether or not the board has appointed a committee of the board to act between board meetings (see section 8.25) (§ 4-33-825). Any director who objects may prevent action by written consent by withholding his or her consent. Thus, it would be impossible to remove a director

by written consent if that director does not consent to the removal.

Many boilerplate forms require the corporate secretary to certify that a specified resolution was duly adopted at a board meeting on a certain date. Subsection (c) (§ 4-33-821(d)) allows a corporation to describe an action by written consent as a "meeting vote" and subsection (b) (§ 4-33-821(b)) indicates the effective date of the vote and empowers a corporate secretary to sign such a form when an action has been approved by unanimous written consent. This avoids the necessity of trying to



convince a non-lawyer that approval of an action by written consent is really the same as approving an action at a meeting.

\*The version of this section enacted by Arkansas differs from the Model Act.

### Official Comment to Section 8.22 (A.C.A. § 4-33-822)

#### 1. *Regular Meeting*

If the time and place of a board meeting is fixed by the bylaws or by the board it is treated as a regular meeting. See section 8.20 (§ 4-33-820). At the beginning of the year nonprofit boards may set the time and place for a series of meetings for the entire year. If so, these meetings are regular meetings. Regular meetings of the board may be held without notice of the purpose of the meeting unless the articles, bylaws or section 8.22 (c) (§ 4-33-822(c)) provide otherwise. If everything had to be noticed, the ability of the board to deal with matters arising just before the meeting would be limited. In addition, absent a waiver of notice, doubt would be cast on actions taken where the notice was inadvertently omitted. While notice of agenda items is not required, good practice usually results in directors' receiving prior notice of matters that will be considered at a regular directors' meeting. An alert director should anticipate that any matter may be raised at a regular directors' meeting.

#### 2. *Special Meeting*

If the time and place of a directors' meeting is not fixed by the bylaws or the board, it is a special meeting. Unless the articles, bylaws or subsection (c) (§ 4-33-822(c)) applies, special meetings must be preceded by at least two days' notice of the date, time, and place, but not the purpose of the meeting. The underlying policy is the same as that of regular meetings. Directors given notice of the time and location of the meeting should be prepared to discuss any matter that is raised at the meeting. This allows directors to act expeditiously when the need to do so arises.

#### 3. *Special Notice Requirements*

Nonprofit corporations, unlike business corporations, frequently operate with self-perpetuating boards of directors. In many

instances the need for speed and flexibility requires directors to consider matters that were not anticipated at the time the meeting was called. However, in corporations without members, directors can approve certain fundamental corporate changes that are significant to the corporation. These changes include amendment of articles, amendment of certain bylaw provisions, mergers, sale of all or substantially all of the assets of a corporation, and dissolution. Such corporate changes usually require significant considered action and a period of time during which the directors can reflect on the wisdom of proceeding. Where there are no members, these matters can be approved by the board alone, without subsequent member action. To allow a time for consideration and reflection the Model Act (§ 4-33-101 et seq.) requires that the directors be given at least seven days' written notice that these matters will be voted upon at a directors' meeting.

Nonprofit corporations with self-perpetuating boards differ in another way from nonprofit corporations with members and business corporations. In nonprofit corporations with self-perpetuating boards, the directors can be removed by a vote of the board. Section 8.08(h) (§ 4-33-808(h)). (In addition, in the limited circumstances set forth in section 8.08(i) (§ 4-33-808(i)), a board may remove a director elected by the members.) Due process as well as sections 8.08(e) and 8.22(c) (§§ 4-33-808(e) and 4-33-822(c)) require that notice of any proposed removal be given to all directors.

The notice requirements of section 8.22 (§ 4-33-822) can be waived pursuant to section 8.23 (§ 4-33-823). Moreover, the directors can approve any of these actions by unanimous written consent. See section 8.21 (§ 4-33-821).

### Official Comment to Section 8.23 (A.C.A. § 4-33-823)\*

A director may waive notice either before or after a meeting. The directors may

even waive failure to give a notice. Waiver may not be oral but must be in writing,

signed by the director who did not receive notice. A waiver should be delivered to the secretary for inclusion in the corporate records.

A director waives his or her right to object to the required notice by attending a meeting without objecting to the improper notice. A director who wishes to attend a meeting but preserve the right to

object to improper notice must object upon arriving at the meeting or prior to voting on a matter improperly noticed and not thereafter vote for or assent to the object-to matter.

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 8.24 (A.C.A. § 4-33-824)\***

In the absence of a contrary provision in the articles or bylaws, a quorum of the board of directors consists of a majority of the directors in office immediately before a board meeting begins. Except as otherwise provided in the Model Act (§ 4-33-101 et seq.), the articles or the bylaws, if a quorum is present, the affirmative vote of a majority of directors present is the act of the board. See section 8.31(e) (§ 4-33-831(e)). The articles or bylaws may set a higher quorum or mandate a greater vote to approve an action. The quorum or vote may be set as high as 100 percent of the directors.

The Model Act (§ 4-33-101 et seq.) prohibits the quorum from being fewer than the greater of one-third of the directors in office or two directors. For example, if a corporation has five directors and two resign, the quorum could not be less than two of the remaining three directors.

Some nonprofit corporations have categories of directors. For example, a trade association may have some directors elected by members from different geographic regions of a state. Section 8.24 (§ 4-33-824) allows the articles or bylaws to require that a certain number or percent of directors from each region be present and vote for a proposal before it is adopted.

Section 8.24(b) (§ 4-33-824(b)) authorizes quorum breaking by requiring a quorum to be present when a vote is taken. Assume, for example, that a corporation has seven directors, the quorum is four, and four directors are present. If a director is about to lose a vote, he or she can leave the meeting before the vote is taken thereby breaking the quorum and preventing the remaining three directors from acting on behalf of the corporation. Prior to breaking a quorum, particularly if serious harm is done to the operations or assets of a corporation, the quorum-breaking director should consider his or her duties of care and loyalty.

The Model Act (§ 4-33-101 et seq.) describes a quorum in terms of the number of directors in office, not the number of directors authorized. This is because nonprofit corporations frequently operate with significantly fewer directors than the number authorized. However, individual nonprofit corporations are free to base their quorum requirements on the authorized number of directors.

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 8.25 (A.C.A. § 4-33-825)\***

Section 8.25 (§ 4-33-825) deals with committees of the board of directors that exercise the powers of the board. The provisions of sections 8.20—8.24 (§§ 4-33-820 — 4-33-824) govern action and procedures of board committees as these committees are exercising the powers of the board.

The board may delegate non-board functions to committees or individuals

apart from the provisions of section 8.25 (§ 4-33-825). As these committees and individuals are not exercising board powers, the provisions of section 8.25 (§ 4-33-825) do not apply to them. The directors must meet their duties under sections 8.30 and 8.31 (§§ 4-33-830 and 4-33-831) when delegating board or non-board functions.

Board committees may be established in the absence of an article or bylaw



provision prohibiting them or limiting their scope. To ensure there is a broad consensus in appointing a board committee and its members, section 8.25(b) (§ 4-33-825(b)) requires a greater vote than would normally be required for board action. The vote required is the greater of the majority of the directors in office or such higher number as the articles or bylaws require to take action under section 8.24 (§ 4-33-824).

Except as limited by the articles, bylaws or subsection (e) (§ 4-33-825(e)), a board committee may exercise the board's authority under section 8.01 (§ 4-33-801) to the extent specified by the board in the resolution establishing the committee or to the extent set forth in the articles or bylaws. Nonprofit corporations frequently make use of committees and delegate responsibility to them for developing long-term plans, supervising investments, raising money, making grants, and evaluating management. Section 8.30 (§ 4-33-830) recognizes the diverse purposes that committees may serve and provides that a board member may rely on information and reports of these committees if the director is not a member of the committee and if the director reasonably believes the committee merits confidence.

"Section 8.25(f) makes clear that although the board of directors may delegate to a committee the authority to take action, the designation of the committee, the delegation of authority to it, and action by the committee will not alone constitute compliance by a noncommittee board member with his responsibility under section 8.30. On the other hand, a

noncommittee director also will not automatically incur liability should the action of the particular committee fail to meet the standard of care set out in section 8.30. The noncommittee member's liability in these cases will depend upon whether he failed to comply with section 8.30(b) (3). Factors to be considered in this regard will include the care used in the delegation to and supervision over the committee, and the amount of knowledge regarding the particular matter which the noncommittee director has available to him. Care in delegation and supervision includes appraisal of the capabilities and diligence of the committee directors in light of the subject and its relative importance and may be facilitated, in the usual case, by review of minutes and receipt of other reports concerning committee activities. The enumeration of these factors is intended to emphasize that directors may not abdicate their responsibilities and secure exoneration from liability simply by delegating authority to board committees. Rather, a director against whom liability is asserted based upon acts of a committee of which he is not a member avoids liability if the standards contained in section 8.30 are met.

"Section 8.25(f) has no application to a member of the committee itself. The standard applicable to committee members is set forth in section 8.30(a)." Official Comment to Model Business Corporation Act Section 8.25 (§ 4-27-825).

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\*The version of this section enacted by Arkansas differs from the Model Act.

### Official Comment to Section 8.30 (A.C.A. § 8-33-830)

#### 1. General Standards of Conduct

Section 8.30(a) (§ 4-33-830(a)) sets forth the general standards of conduct for directors of nonprofit corporations. It settles the dispute as to whether directors of nonprofit corporations should meet the general business standards or the trustee standards. See "Duties of Charitable Trust, Trustee and Charitable Corporation Directors," *Real Property, Probate and Trust Journal* 545 (1967); *Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974). Also see Official Comment to Section 8.30 of the

Model Business Corporation Act (§ 4-27-830).

Depending on the status of state law, section 8.30 (§ 4-33-830) will replace, modify, clarify or set forth the basic standards that govern the conduct of directors of nonprofit corporations. The standards set forth in section 8.30 (§ 4-33-830) are the exclusive standards that govern such conduct. While the exact meaning and application of these standards is left to court decisions, section 8.30 (§ 4-33-830) provides the basis upon which these decisions can be made. Except in subsection (e) (§ 4-33-830(e)), the Model Act (§ 4-33-

101 et seq.) adopts the language used in the Model Business Corporation Act (§ 4-27-101 et seq.).

States adopting the Model Act (§ 4-33-101 et seq.) may have statutory or common law rules that might apply a trust rule to director conduct covered by section 8.30 (§ 4-33-830). Section 8.30 (§ 4-33-830) preempts these rules even though the corporation, as distinguished from its director, may hold or be deemed to hold property in trust or subject to restrictions.

While the same language is used, the language is so broad and the differences between public benefit, mutual benefit, religious and business corporations so significant that different factors are relevant in determining whether the standards have been met. A business corporation operates to maximize profits and to economically benefit shareholders. The object of mutual benefit corporations is to provide benefits to and services for members, not to maximize profits. Members may have an economic or noneconomic interest in mutual benefit corporations. Public benefit and religious corporations are quite different. They operate for a public, charitable or religious purpose, not to maximize profits. Their members' interest is not economic but directed toward the corporations' public, charitable or religious purposes. Due to the different nature and objectives of nonprofit corporations, directors of public benefit, mutual benefit, religious and business corporations are not in like positions or operating under similar circumstances.

## **2. Duty of Care**

Section 8.30(a) (§ 4-33-830(a)) requires that a director in discharging his or her duties act with the care of an ordinarily prudent person in a like position under similar circumstances. This familiar language allows directors of nonprofit corporations to exercise their judgment with due regard to the nature, operations, finances, and objectives of their organizations. The "ordinarily prudent person" concept is used in various contexts. In the context of nonprofit corporations it applies to directors who balance potential risks and rewards in exercising their duties as directors. It is intended to protect directors who innovate and take informed risks to carry out the corporate goals and objectives. The directors need not be right, but they must act with common sense and

informed judgment. The duty of care recognizes that directors are not guarantors of the success of investments, activities, programs or grants. It allows leeway and discretion in exercising judgment.

Directors must spend enough time on the corporation's affairs to be reasonably acquainted with matters demanding their attention. Such attention involves attendance at meetings and review and understanding of material submitted to the board. It also requires directors to request and receive sufficient information so that they may carry out their responsibilities as directors.

In appropriate circumstances the duty of care requires reasonable inquiry. Where a problem exists or a report on its face does not make sense, a director has a duty to inquire into the surrounding facts and circumstances. The inquiry required is the inquiry an ordinarily prudent person in a like position would make under similar circumstances.

The concept of "in a like position" takes into account the fact that directors of nonprofit and business corporations are not in like positions, but have different goals, objectives and resources. For example, many nonprofit corporations operate with little financial backing. Their directors might reasonably conclude that more risks or less risks were justified due to the precarious financial condition of the corporation. Similarly, foundation directors could reasonably conclude that all or a certain percent of the foundation's grants should go to untried and innovative programs with little chance of success, but that would result in significant benefits if successful.

Two distinguishing factors of nonprofit corporations are that their directors may be serving without compensation and are attempting to promote the public good. Courts may take these factors into consideration in determining whether directors are liable with respect to performance of their duties. This does not mean that directors can ignore their responsibilities because they are volunteers or have no economic interest in the corporation or its operations.

The concept of "under similar circumstances" relates not only to the circumstances of the corporation but to the special background, qualifications, and management experience of the individual



director and the role the director plays in the corporation. In many public benefit corporations an important role of directors is fund-raising. Many directors are elected to the board to raise money or because of financial contributions they have made to the corporation. These individuals may have no particular skill or background that otherwise would be helpful to the corporation. No special skill or expertise should be expected from such directors unless their background or knowledge evidences some special ability. Such individuals upon becoming directors are obligated to act as directors and may not simply act as figureheads ignoring problems. However, their role should be considered in determining whether they have met their obligations under section 8.30 (§ 4-33-830).

Similarly the role of employee-directors should be considered in determining liability under section 8.30 (§ 4-33-830). They are the individuals upon whom volunteer directors should be able to rely. See discussion of "Reliance" *infra*. Their role is crucial to the functioning of many nonprofit corporations. They should be expected to have a more complete grasp of the corporation's activities and should be expected to play an active role in monitoring, problem solving, and decision-making.

A court should not be harsh in second-guessing directors who in good faith make a judgment that proves incorrect. "Although some decisions turn out to be unwise or the result of a mistake of judgment, it is unreasonable to reexamine these decisions with the benefit of hindsight. Therefore, a director is not liable for injury or damage caused by his decision, no matter how unwise or mistaken it may turn out to be, if in performing his duties he met the requirements of section 8.30." Official Comment to Section 8.30 of the Model Business Corporation Act (§ 4-27-830).

### 3. The Business Judgment Rule

Although it may seem anomalous to apply the business judgment rule to nonprofit corporations, a few courts have so applied it. *Yarnall Warehouse & Transfer Inc. v. The Three Ivory Brothers Moving Company*, 226 So. 2d 887 (Fla. Dist. Ct. App. 1969). See *Beard v. Achenbach Memorial Hospital*, 170 F.2d 859 (10th Cir. 1948).

While the application of the business judgment rule to directors of nonprofit corporations is not firmly established by the case law, its use is consistent with section 8.30 (§ 4-33-830). Moreover, in the nonprofit context the business judgment rule should apply to discretionary matters voted upon by the board of directors and not just those that can be characterized as "business" decisions. Decisions relating to funding a project or organization, determining what play to produce or what animals to have in a zoo could all fall within the business judgment rule.

If a director has met the standards of section 8.30 (§ 4-33-830), there is no need to apply the business judgment rule. If the rule applies it would be operative only if compliance with section 8.30 (§ 4-33-830) has not been established.

### 4. Duty of Loyalty

The general duty of loyalty of directors of nonprofit corporations is set forth in the mandate of section 8.30 (§ 4-33-830) that directors act in good faith in a manner they reasonably believe to be in the best interests of the corporation. Development of standards in this area is left to judicial resolution. See *Mile-O-Mo Fishing Club, Inc. v. Noble*, 62 Ill. App. 50, 210 N.E.2d 12 (1965).

Sections 8.31—8.33 (§§ 4-33-831 — 4-33-833) deal with particular aspects of the general duty of loyalty. In setting forth the general standards in section 8.30 (§ 4-33-830) and particular standards in sections 8.31—8.33 (§§ 4-33-831 — 4-33-833), it is the intent of the Model Act (§ 4-33-101 *et seq.*) to reject the strict trustee standard and to set forth the exclusive standards under which courts should resolve duty of loyalty questions. In some states it may be necessary to negate the application of various code sections that might otherwise improperly be applied to nonprofit corporations.

### 5. Good Faith

A precondition to a director discharging his or her duties is that the director act in good faith. While this is a subjective requirement, a court will look to objective facts and circumstances to determine whether the good faith requirement is met. A court generally will look to the director's state of mind to see if it evidenced honesty and faithfulness to the director's duties and obligations, or whether there was an intent to take ad-

vantage of the corporation. A director of a religious corporation in making a good faith determination may consider what the director believes to be: (1) the religious purpose of the corporation; and (2) applicable religious tenets, canons, laws, policies and authority.

#### **6. Reasonable Belief That Action Is in the Best Interests of the Corporation**

The requirement that the director act in a manner the director reasonably believes is in the best interests of the corporation is both objective and subjective. It is objective in that the director must reasonably believe the action is in the best interests of the corporation. It is subjective in that the director must in fact believe the action is in the best interests of the corporation. As with the good faith requirement, a court is likely to look to objective facts to determine whether a director's state of mind appears unreasonable and whether the director really believed that the action was in the best interests of the corporation.

#### **7. Reliance**

So long as a director does not have knowledge that would make reliance unwarranted, a director may rely on information, opinions, reports, and statements prepared and presented by the individuals and committees specified in section 8.30(b) (§ 4-33-830(b)). The right to rely is based on the practical need of directors of nonprofit corporations to rely on experts, staff, committees composed in whole or part of non-board members and committees of the board. With one exception a director may only rely on information from individuals or committees who the director believes to be competent. See section 8.30(b)(1) and (2) (§ 4-33-830(b)(1) and (2)). Under section 8.30(b)(3) (§ 4-33-830(b)(3)) in relying on committees of the board of which the director is not a member, the director must believe that the committee merits "confidence," not that it is "competent." "In section 8.30(b)(3), the concept of 'confidence' is substituted for 'competence' in order to avoid any inference that technical skills are a prerequisite." Official Comment to Section 8.30 of the Model Business Corporation Act (§ 4-27-830). The requirement that a director must not have knowledge that would cause reliance to be unwarranted means

that a director cannot rely on that which he or she knows to be unreliable.

In most circumstances a director is entitled to rely on reports prepared by the individuals or committees specified in subsection (b) (§ 4-33-830(b)). Where, however, a director has a reasonable basis to be suspicious or is in fact suspicious, the general duty of care set forth in section 8.30 (§ 4-33-830) requires the director to make further inquiry. In addition to the requirement that a director must reasonably believe that the material is reliable, the director must in fact rely on the material. In order to rely on a report a director must have read it, been present at a meeting where it was presented or otherwise have evaluated it.

#### **8. Delegation**

Directors of a nonprofit corporation may delegate authority to officers, employees or agents of the corporation so long as the affairs of the corporation are managed under the direction of the board. See section 8.01(b) (§ 4-33-801(b)). "Since the board may delegate or assign to appropriate officers of the corporation the authority or duty to exercise powers that section 8.01 does not require the board to retain, directors are not personally responsible under section 8.30 for actions or omissions of officers, employees, or agents of the corporation so long as the directors, complying with the standard of care set forth in section 8.30, have acted reasonably in delegating responsibility." Official Comment to Section 8.30 of the Model Business Corporation Act (§ 4-27-830).

#### **9. Exoneration**

Section 8.30(d) (§ 4-33-830(d)) is based in part upon section 8.30(d) of the Model Business Corporation Act (§ 4-27-830(d)) which was based on section 35 of the prior Model Business Corporation Act. Section 8.30(d) (§ 4-33-830(d)) is "self-executing, and the individual director's exoneration from liability is automatic...."

"Section 8.30(d) makes clear that the section will apply whether or not affirmative action was in fact taken. If the board of directors or a committee considers an issue (such as a recommendation of independent auditors concerning the corporation's internal accounting controls) and determines not to take action, the determination not to act is protected by section 8.30. Similarly, if the board of directors or committee delegates responsibility for



handling a matter to subordinates, the delegation constitutes 'action' under section 8.30. Section 8.30(d) applies (assuming its requirements are satisfied) to any conscious consideration of matters involving the affairs of the corporation. It also applies to the determination by the board of directors of which matters to address and which not to address. Section 8.30(d) does not apply only when the director has failed to consider taking action which under the circumstances he is obliged to consider taking." Official Comment to Section 8.30 of the Model Business Corporation Act (§ 4-27-830).

Subsection (d) (§ 4-33-830(d)) deals with one area of potential liability that is not explicitly dealt with by section 8.30 of the Model Business Corporation Act (§ 4-27-830). It provides that a director who has acted in compliance with section 8.30 (§ 4-33-830) "is not liable to the corporation, any member or any other person for any action taken or not taken as a director..." This provision protects directors from claims by third persons. It rejects the holding in *Frances T. v. Village Green Owners Ass'n.*, 43 Cal. 3d 490 (1986). However, a director who personally commits a tort is not protected by the provisions of section 8.30 (§ 4-33-830).

Subsection (e) (§ 4-33-830(e)) deals with another area of potential liability that is not explicitly dealt with by section

8.30 of the Model Business Corporation Act (§ 4-27-830). Subsection (e) (§ 4-33-830(e)) provides that a director is not a trustee with respect to the corporation or any property held by it. Absent subsection (e) (§ 4-33-830(e)), it would be possible to argue that a director meeting his or her duties under section 8.30 (§ 4-33-830) was liable for a breach of trust by improperly using, disposing of, or otherwise dealing with assets held by the corporation in trust. As a result of subsection (e) (§ 4-33-830(e)) this argument has no vitality. A director who meets the standard of section 8.30 (§ 4-33-830), but improperly acts or fails to act in regard to property held in trust, will not be liable. Depending on state law, the corporation may be liable for breach of trust. However, the corporation may not seek indemnification or contribution from the director.

#### 10. Investments

Numerous states have adopted the Uniform Management of Institutional Funds Act. That act deals with the way in which nonprofit organizations hold, manage, and invest their assets. In adopting the Model Act (§ 4-33-101 et seq.) states should consider the applicability of the Uniform Management of Institutional Funds Act to the standards set forth in sections 8.30-8.33 (§§ 4-33-830 — 4-33-833).

### Official Comment to Alternative Section 8.30\*

This alternative section is derived from section 102(b)7 of the Delaware General Corporation Law. It does not change the duty of care. Rather subdivision (d) allows a corporation to limit directors' liability for monetary damages for breaching their duty of care.

It is prospective in application and only applies to acts or omissions occurring after the provision authorized by alterna-

tive section 2.02(b) (5) becomes a part of a corporation's articles of incorporation. Unless a provision authorized by section 2.02(b) (5) is in a corporation's articles the provisions of section 8.30 govern the conduct of directors.

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\*This alternative section was not enacted by Arkansas.

### Official Comment to Section 8.31 (A.C.A. § 4-33-831)\*

#### 1. Applicability of Section 8.31 (§ 4-33-831)

Section 8.31 (§ 4-33-831) applies to a limited category of conflict of interest transactions. Section 8.31 (§ 4-33-831) applies to a transaction if a director: (1) has a direct interest in the transaction; (2)

is a general partner in a partnership or a director, officer or trustee of another entity that has an interest in the transaction; or (3) has a material interest in an entity that has an interest in the transaction. A director has an interest in a transaction if his or her immediate family

members have an interest in the transaction.

Even if section 8.31 (§ 4-33-831) does not apply to a transaction, section 8.30 (§ 4-33-830) may be applicable. For example, a director of a nonprofit corporation may have an immaterial interest in an entity that has a contract with the director's nonprofit corporation. Section 8.31 (§ 4-33-831) would not apply as the director's only interest in the transaction is an immaterial interest. However the general duty of loyalty set forth in section 8.30 (§ 4-33-830) would apply. The director would have to act "in good faith ... in a manner the director reasonably believes to be in the best interests of the corporation." Section 8.30(a) (1) and (3) (§ 4-33-830(a) (1) and (3)).

Section 8.31 (§ 4-33-831), like section 8.30 (§ 4-33-830), rejects the trustee standard. That standard prohibits any transaction between a trust and a trustee. Section 8.31 (§ 4-33-831) also rejects the concept that a director may not obtain any profit from a transaction involving his or her corporation. If the requirements of section 8.31 (§ 4-33-831) are met, a director can make a profit from a transaction involving his or her corporation.

The Model Act (§ 4-33-101 et seq.) recognizes that many individuals are elected to nonprofit boards because of their ability to enter into or cause an affiliate to enter into a transaction with and for the benefit of the corporation. Often landlords, lawyers, bankers, and suppliers are added to a board so the corporation can obtain reduced rent, free or low-cost legal services, loans, and bargain purchases. Ideally, nonprofit corporations would have sufficient money to carry out their purposes and would not have to rely on or plead for favorable treatment. As a practical matter this does not often occur. Therefore the Model Act (§ 4-33-101 et seq.) attempts to provide a tolerable accommodation between the needs of nonprofit organizations and the potential abuses by directors or officers.

## **2. Ways to Comply With Section 8.31 (§ 4-33-831)**

### **a. Public Benefit and Religious Corporations**

There are four ways in which a transaction involving a public benefit or religious corporation may meet the requirements of section 8.31 (§ 4-33-831).

First, a transaction that is fair to the corporation at the time it is authorized or is entered into does not violate the provisions of section 8.31 (§ 4-33-831). Consequently an interested director may always defend a claim that a transaction violates section 8.31 (§ 4-33-831) by showing it was fair to the corporation.

The essence of the fairness test is set forth in *Pepper v. Litton*, 308 U.S. 295, 306 (1939), where the Court stated that in evaluating the fairness of transactions entered into by a corporation and its directors or controlling persons:

Their dealings with the corporation are subjected to rigorous scrutiny ... The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.

Second, if the transaction is approved in advance by the vote of the board of directors or a committee of the board the transaction will not violate section 8.31 (§ 4-33-831) if:

(a) the material facts of the transaction and the director's interest in the transaction were disclosed or known to the board or committee. Although not required, good practice would result in a written record of the facts disclosed or known to the directors. Even if there are no such records and no disclosure was made, this information requirement can be met if the directors at the time they approved the transaction knew the material facts of the transaction and the director's interest in the transaction; and

(b) the directors approving the transaction reasonably believed the transaction was fair to the corporation. It is not necessary to prove that the transaction was in fact fair to the corporation, just that the directors believed it was fair and had a reasonable basis upon which to form this opinion. See discussion of Reasonable Belief, Good Faith, and Reliance in Official Comment to Section 8.30 (§ 4-33-830). Even if the directors were wrong in believing that it was fair, the transaction will not violate section 8.31 (§ 4-33-831) so long as the directors approved it in conformity with section 8.31 (§ 4-33-831); and

(c) the transaction was approved before it was consummated.

Third and fourth, court or attorney general approval of the transaction may be obtained before or after the transaction



was consummated. The Model Act (§ 4-33-101 et seq.) does not specify the method of obtaining attorney general approval. This matter is left to the individual states. Nor does the Model Act (§ 4-33-101 et seq.) specify the grounds upon which a court should approve a transaction. Presumably, however, a court will evaluate the fairness of the transaction after consideration of all relevant facts. If court or attorney general approval is obtained, the transaction cannot be challenged on the ground that it violates section 8.31 (§ 4-33-831).

#### *b. Mutual Benefit Corporations*

There are three ways in which a conflict of interest transaction may meet the requirements of section 8.31 (§ 4-33-831) for a mutual benefit corporation.

First, a transaction that is fair at the time it is entered into meets the requirements of section 8.31 (§ 4-33-831). Second and third, the board of directors or members may approve the transaction either before or after it is consummated. If it is approved by the board or members in conformity with section 8.31 (§ 4-33-831), the person seeking to uphold the transaction does not have to prove it was fair. In each case the directors or members must know or there must have been disclosure of all material facts including the director's interest in the transaction. Member approval is not available to public benefit corporations as members of public benefit corporations have no economic interest in their corporation and in this respect are not analogous to shareholders of business corporations.

#### *3. Vote and Quorum*

Subsection (e) (§ 4-33-831(e)) sets a special quorum and vote requirement when the board votes on a conflict of interest transaction. A quorum is present and a transaction is approved by the board when a majority of the directors on the board who have no direct or indirect interest in the transaction vote to authorize the transaction. The articles or bylaws may impose a higher quorum or vote requirement. See sections 7.22 and 7.23 (§§ 4-33-722 and 4-33-723). In no event may one director approve a conflict of interest transaction.

An interested director may be present when the vote is taken. In some instances good practice requires the director's presence at a meeting to answer questions

about the transaction. While it might be desirable to request an interested director to leave prior to the vote, the Model Act (§ 4-33-101 et seq.) does not require the director or officer to leave during the discussion or the vote. In fact the interested director may vote on the transaction if the transaction is otherwise approved as provided in subsection (b) or (c) (§ 4-33-831(b) or (c)).

#### *4. Materiality*

Section 8.31 (§ 4-33-831) applies to transactions between a nonprofit corporation and an entity in which the director of the nonprofit corporation has a "material" interest.

Not every transaction in which a director has an interest will involve a material interest. Some transactions will involve an immaterial interest. An interest is material if there is a substantial likelihood that a reasonable person would consider it important in deciding what action to take. See *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). The richer the director and the smaller the transaction the less likely it is that the transaction will be material.

Section 8.31 (c) (§ 4-33-831(c)) requires disclosure or knowledge of the "material" facts of a conflict of interest transaction prior to approval of the transaction by the directors or members. A fact is material if there is a substantial likelihood that a reasonable person would consider it important in deciding how to vote. See *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

#### *5. Additional Requirements*

Nonprofit corporations may prohibit or impose additional requirements for approval of transactions involving interested directors and officers. A supermajority vote, board and not just committee approval, and other specified procedures may be required. Subsection (g) (§ 4-33-831(e)) allows these additional requirements to be set forth in the articles, bylaws or a resolution of the board.

#### *6. Remedies*

Section 8.31 (§ 4-33-831) does not specify remedies for a violation of section 8.31 (§ 4-33-831). However the underlying philosophy of sections 8.30 and 8.31 (§§ 4-33-830 and 4-33-831) is contrary to the strict trust concept that interested directors can never obtain a profit when dealing with their corporation.

A court should enter an order that provides an equitable and fair remedy to the corporation taking into account any benefits the corporation received. A court should determine whether the breach of section 8.31 (§ 4-33-831) was technical or substantive, whether there was an attempt to deal openly and fairly with the corporation and to act in good faith in furthering the corporation's best interests. In particularly egregious cases involving fraudulent or malicious conduct, a court may grant exemplary damages.

Courts may wish to distinguish between

transactions that only involve an interested director and transactions in which an interested director or officer has an indirect material interest. In the latter case it may be unfair to invalidate a transaction between a nonprofit corporation and a third party or to order the third party to pay damages. The nature of the remedy is left to the discretion of the courts.

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 8.32 (A.C.A. § 4-33-832)**

Section 8.32 (§ 4-33-832) prohibits all loans to and guaranties for officers and directors. As potential abuse in this area is great and statutorily distinguishing between appropriate and inappropriate loans is difficult, the Model Act (§ 4-33-101 et seq.) continues the policy of the

prior Model Act by prohibiting loans and guaranties. Advances of money from petty cash and for travel and other corporate purposes are not loans within the meaning of section 8.32 (§ 4-33-832) and consequently are not prohibited.

### **Official Comment to Section 8.33 (A.C.A. § 4-33-833)**

Section 13.01 (§ 4-33-1301) prohibits distributions except those authorized by section 13.02 (§ 4-33-1302). See section 1.40(10) (§ 4-33-140(11)). Section 8.33(a) (§ 4-33-833(a)) provides that a director who votes for or assents to a prohibited distribution is not liable for such action if the director complies with the standards of conduct set forth in section 8.30 (§ 4-33-830). Of course, a director who receives a distribution prohibited by section 13.01 (§ 4-33-1301) is obligated to return the distribution to the corporation.

A director who breaches his or her duties under section 8.30 (§ 4-33-830) in voting for or assenting to a prohibited

distribution is liable to the corporation for the amount of the improper distribution.

Section 8.33(b) (§ 4-33-833(b)) allows a director who is liable for an unlawful distribution to receive contribution from the directors, if any, who voted for or assented to the distribution without complying with section 8.30 (§ 4-33-830) and from each person who received the unlawful distribution. These persons may include members, directors, officers and controlling persons of the corporation. See section 13.01 (§ 4-33-1301). The exact amount each will have to contribute is left to the equitable powers of the courts.

### **Official Comment to Section 8.40 (A.C.A. § 4-33-840)**

Unless otherwise provided in the articles or bylaws, a corporation shall have a president, secretary, treasurer and such other officers as are appointed by the board. The bylaws may do away with the traditional titles for officers and provide a series of unique titles for those who serve as corporate officers. The board shall appoint all corporate officers. Even if an individual is not designated as "secretary" of the corporation, section 8.40(b) (§ 4-33-

840(b)) requires the bylaws or the board to delegate to an officer responsibility for preparing minutes of the directors' and members' meetings and for authenticating corporate records. The Model Act (§ 4-33-101 et seq.) treats this individual as the "secretary" of the corporation regardless of his or her corporate title. See section 1.40(31) (§ 4-33-140(32)).

In many instances nonprofit corporations are run by and day-to-day responsi-



bility is vested in an employee who is an officer of the corporation, whether called executive director, administrator, chief administrator or by some other name. The president, if any, is a volunteer who is given the title of president in recognition of the significant contributions he or she has made or is making to the organization. The president is not involved in the day-to-day activities of the organization, and may or may not be the most significant member of its board of directors. Under these circumstances the title of "president" may be misleading. The term

is certainly not analogous to the president of a business corporation.

In many nonprofit organizations substantial authority rests in an executive director, a full-time officer who runs the day-to-day activities of the corporation and makes basic decisions relating to corporate activities. In such instances the bylaws or a resolution of the board should specify the power and authority of the executive director consistent with the requirement that the affairs of the corporation be managed under the direction of the board.

### **Official Comment to Section 8.41\***

Section 8.41 deals with the authority (sometimes called "actual authority") of corporate officers. It provides that these officers shall have the authority set forth in the bylaws, in the resolutions of the board, or that which is delegated to them by an officer authorized to do so by the board.

In addition, certain officers may have limited authority as a result of a particular office they hold. For example, the executive director of a nonprofit organization may have considerable authority as a result of being executive director. Cases dealing with the inherent authority of the president or other officers of a business

corporation are not necessarily consistent with the nature of these offices in the nonprofit context. For example, in some nonprofit organizations the president may not be involved in the day-to-day activities or decision-making. If not, the president's role is different than that of the president of a business corporation.

Officers may also have the power to bind the corporation. See Section 8 of the Restatement of the Law of Agency, Second. Also see section 8.45 (§ 4-33-845).

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\*This section was not enacted by Arkansas.

### **Official Comment to Section 8.42 (A.C.A. § 4-33-842)**

Section 8.42 (§ 4-33-842) provides that nondirector officers with discretionary authority have the same general duty of care and loyalty as that of directors set forth in section 8.30 (§ 4-33-830). In nonprofit corporations, particularly public benefit or religious corporations where the board of directors is usually composed of volunteers, full-time paid officers have important and significant duties and responsibilities. "Nondirector officers with more limited discretionary authority may be judged by a narrower standard, though every corporate officer or agent owes duties of fidelity, honesty, good faith, and fair dealing to the corporation." Official Comment to Model Business Corporation Act Section 8.42 (§ 4-27-842).

Section 8.42 (§ 4-33-842) allows nondirector officers to rely on certain in-

formation, opinions, reports and statements when they do not have knowledge concerning the matter that would make that reliance unwarranted. In the absence of actual knowledge that records presented by the secretary are not truthful or accurate, third persons may rely on the truthfulness and accuracy of such records.

Officers, particularly those who are paid, have a responsibility to actively carry out their duties and obtain information relevant to their position. This information may require the officers to make further inquiries and prevent them from relying on reports that could be relied upon by directors.

In general, the Official Comment to Section 8.30 (§ 4-33-830) is applicable to nondirector officers.

**Official Comment to Section 8.43 (A.C.A. § 4-33-843)**

Section 8.43 (§ 4-33-843) allows an officer to resign by giving written or oral notice to the corporation and specifies when the resignation is effective.

Section 8.43(b) (§ 4-33-843(b)) provides that the board may remove any officer, at any time, with or without cause. An officer

so removed may not sue for specific performance of any contract or agreement to be employed as an officer. Such removal is without prejudice to the former officer's right to bring an action for damages for breach of contract. See section 8.44 (§ 4-33-844).

**Official Comment to Section 8.44 (A.C.A. § 4-33-844)**

"Section 8.43 makes clear that the appointment of an officer does not itself create contract rights in the officer. The removal of an officer with contract rights is without prejudice to his later enforcement of contract rights in a suit for damages for breach of contract. See the Official Comment to section 8.43. Similarly, an

officer with an employment contract who prematurely resigns may be in breach of his employment contract. The mere appointment of an officer for a term does not create a contractual obligation on his part to complete the term." Official Comment to Model Business Corporation Act Section 8.44 (§ 4-27-844).

**Official Comment to Section 8.45 (A.C.A. § 4-33-845)**

Section 8.45 (§ 4-33-845) is a safe harbor that does not diminish the apparent authority officers may have under common law.

Section 8.45 (§ 4-33-845) allows third persons to rely on the signatures of specified officers of a nonprofit corporation as

indicating authority to act on behalf of the corporation unless the third persons have actual knowledge that the signing officers have no authority. This provision (§ 4-33-845) is particularly helpful in the nonprofit context where the authority of officers may be less than clear.

*Subchapter E***INDEMNIFICATION****INTRODUCTORY COMMENT**

The indemnification provisions of the Model Act (§ 4-33-101 et seq.), as in all modern corporation enactments, are central to the Act (§ 4-33-101 et seq.) They are closely related to the standards of conduct established in section 8.30 (§ 4-33-830). Such provisions are particularly important in the nonprofit setting in that they establish essential protections for conflicts between protecting the directors and protecting the public interests from which nonprofit corporations spring.

**1. Background of Indemnification Provisions for Nonprofit Corporations**

Prior to the enactment of statutory provisions enabling nonprofit corporations to indemnify their directors and officers against liabilities incurred in serving the corporation, case law gave uncertain answers to questions about the extent to

which such corporations could or should indemnify officers and directors against personal liabilities. Indemnity depended entirely upon the often somewhat bizarre application of the principles of charitable trusts, agency or contracts. In some instances it was held that, in the absence of a statute expressly enabling the corporation to make indemnification, there is no right to indemnification. *Texas Society v. Fort Bend Chapter*, 590 S.W.2d 156 (Tex. Civ. App. 1979). It was also uncertain to what extent a corporation might purchase insurance to indemnify directors or enter into contractual arrangements to do so.

Historically there was little perceived need for statutory attention in that nonprofit directors were rarely sued. Indemnification provisions for nonprofit corporations are generally derived from the state's business corporation act by making



the act applicable to nonprofit corporations or by parallel enactment. Recently, the increased incidence of litigation against directors of both business and nonprofit corporations coupled with well-publicized findings of liability have made the subject of indemnification one of intense interest among corporation officials.

## **2. Policy Issues Raised by Indemnification**

Nowhere is the contrast between competing policy considerations relating to indemnification more apparent than in the nonprofit corporation. Such corporations differ substantially from business corporations which are generally organized to make a profit in that nonprofit corporations exist for innumerable purposes. Throughout the Act (§ 4-33-101 et seq.) corporations are divided among public benefit, mutual benefit and religious organizations. While mutual benefit corporations are akin to business corporations, public benefit and religious corporations may or may not have members to whom directors are accountable. To allow directors of these corporations total exoneration from the consequences of conduct that is either wrongful or carried out in bad faith would violate tenets of public morality and trust.

At the same time, corporations must attract persons, usually of some stature in the community, who will serve without compensation or other direct economic in-

come. To ask them to bear the considerable expense and potential for Draconian liability whenever their conduct is challenged would be unfair and inappropriate in that the reserve of persons willing to serve would be soon depleted.

Indemnification against conduct that is criminal under state or federal statutes may be particularly sensitive in that it may be viewed as frustrating public policy. On the other hand, there are instances where criminal sanctions may be imposed where the conduct taken was not knowingly unlawful and was believed to be in the best interest of the corporation.

The ability of the corporation to provide insurance that is broader than permissible indemnification further complicates the issues of public policy and public trust. Such insurance, however, is in itself limited by public policy and the available coverage. It is increasingly viewed as an essential complement to statutory indemnification especially where the corporation may have insufficient assets to satisfy indemnification obligations, or be reluctant to satisfy them from funds held for public, charitable or religious purposes.

Ideally the indemnification provisions will resolve the basic tension among necessary protection for the corporate officials, necessary protection of the corporation, and necessary protection of the public.

## **Relationship of Indemnification to the Revised Model Business Corporation Act Provisions**

The Act (§ 4-33-101 et seq.) closely follows the Revised Model Business Corporation Act (§ 4-27-101 et seq.) with respect to both standards of conduct and indemnification. This is consistent with the conclusion of recent cases that the relationship of directors to the nonprofit corporation is more akin to that of directors of business corporations than to that of trustees to their beneficiaries. *Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries*, 38 F. Supp. 100 (D.D.C. 1974).

As in the revised MBCA (§ 4-27-101 et seq.) it is assumed that a director who acts consistently with the standard of care established in Section 8.30 (§ 4-33-830) will be indemnified against both judgments and expenses. The standard of "good faith and reasonable belief that the conduct was in or not opposed to the best interests of the corporation" for indemnification, however, is broader. It may provide indemnification in limited instances where a director or officer may have breached a duty to the corporation.

## **Official Comment to Section 10.01 (A.C.A. § 4-33-1001)**

Section 10.01 (§ 4-33-1001) authorizes amendments to a corporation's articles of incorporation. The amendments may

modify, delete, change or add provisions to a corporation's articles.

An amendment may be adopted if it: (1)

results in provisions permitted in the articles (see sections 2.02 and 2.06(b)) (§§ 4-33-202 and 4-33-206(b)); (2) does not contravene or delete provisions the Model Act (§ 4-33-101 et seq.) requires the articles to contain (see section 2.02(a)) (§ 4-33-202(a)); and (3) is adopted pursuant to the provisions of chapter 10 (§ 4-33-1001 et seq.).

Whether the first two tests are met is determined as of the effective date of the amendment. The third test is determined as of the time the amendment is adopted.

Members' rights are protected by: (1) the right to vote on amendments, including the right to vote by class in appropriate cases (sections 10.03 and 10.04) (§ 4-33-1003 and 4-33-1004); (2) the duty of the board to approve amendments consistent with its obligations under section 8.30 (§ 4-33-830); and (3) contractual commitments made by the corporation.

#### **Official Comment to Section 10.02 (A.C.A. § 4-33-1002)**

Section 10.02 (§ 4-33-1002) distinguishes between corporations with members and those without members. If a corporation has members, subsection (a) (§ 4-33-1002(a)) allows directors to approve specified amendments, as the amendments do not adversely affect members' substantive rights.

If a corporation does not have members, subsection (b) (§ 4-33-1002(b)) allows the board to amend the articles by a vote of a majority of the directors in office at the time the amendment is adopted. The notice of the meeting to approve the amendment must be in accordance with section 8.22 (§ 4-33-822) and state that one purpose of the meeting is to consider an amendment to the articles.

It is not necessary that the directors be provided with a copy or summary of the amendment prior to the meeting so long as the meeting notice states the general

A corporation may have entered into some oral or written contractual relationship with its members. A person may, for example, have joined an organization based in part on the representation that certain benefits would be provided under specified conditions. If so, the corporation's obligations may be enforced apart from any provisions contained in the articles. The articles may require an amendment to be approved by a specified person or persons. See section 10.30 (§ 4-33-1030). If so, that approval must be obtained prior to amending the articles.

As section 10.01 (§ 4-33-1001) provides broad power to amend a corporation's articles, the Model Act (§ 4-33-101 et seq.) does not enumerate the myriad of possible amendments or require the articles to include an express-power of amendment.

nature of the amendment. Failure to give proper notice may be waived under the conditions set forth in section 8.23 (§ 4-33-823).

Even if a corporation does not have members, an amendment to the articles may require the approval of a specified person or persons. Section 10.30 (§ 4-33-1030). The articles may, for example, require the approval of a related organization, governmental entity, specified individual or group of delegates.

If a corporation does not have members, its incorporators, until directors have been chosen, may exercise the power of the directors in amending articles. The incorporators must follow the rules applicable to directors.

Amendments may be adopted by incorporators or by the directors by unanimous written consent. See section 8.21 (§ 4-33-821).

#### **Official Comment to Section 10.03 (A.C.A. § 4-33-1003)**

If a corporation has members, section 10.03 (§ 4-33-1003) requires that an amendment to its articles be approved by the members by two-thirds of those voting or a majority of the voting power, whichever is less. See section 1.40(1) (§ 4-33-

140(1)). Section 10.04 (§ 4-33-1004) may require a class vote.

An amendment may be approved by the members at a membership meeting, by written ballot or by written consent. See sections 7.01, 7.02, 7.04 and 7.08 (§§ 4-33-



701, 4-33-702, 4-33-704 and 4-33-708). The notice of the meeting or the materials soliciting the approval must contain or be accompanied by a copy or summary of the amendment. This is to insure that the members will be informed prior to voting on the amendment.

While the board may propose an amendment for adoption by members, board approval is not required for certain amendments. Board approval is not required for amendments relating to the number of directors, the composition of the board, the term of office of directors, or the method by which directors are elected or selected. When board approval is not required, the board may propose amendments to the articles.

Subdivision (b) (§ 4-33-1003(b)) allows adoption of an amendment to be conditioned on some higher vote than would normally be required or upon the happening of an event or events. This ability to conditionally approve amendments pro-

vides flexibility to the corporation and allows more than the simple alternative of approving or disapproving.

An amendment must also receive any approval required by section 10.30 (§ 4-33-1030). Section 10.30 (§ 4-33-1030) may, for example, require an amendment to be approved by a related organization, governmental entity, specified individual, or group of delegates.

If the board initiates an amendment, it will normally recommend the amendment to the members. However, in some instances the board may have a conflict of interest and be unable to make a recommendation or for some reason believe it is inappropriate to do more than present the amendment to the members for their approval. If so, the board may simply submit the amendment to the members for their approval. The board may indicate why it is unable to present a recommendation, but this is not required.

#### **Official Comment to Section 10.04 (A.C.A. § 4-33-1004)**

Section 10.04 (§ 4-33-1004) distinguishes between public benefit, religious and mutual benefit corporations. It requires a class vote to amend articles of incorporation of public benefit and mutual benefit corporations regardless of a contrary provision in the articles if the amendment would make any of the changes specified in subsection (a) or (b) (§ 4-33-1004(a) or (b)).

Subsection (a) (§ 4-33-1004(a)) deals with public benefit corporations. A membership in a public benefit corporation does not represent a valuable economic right. It represents the right to vote for directors and thereby participate in the decision as to who will control the corporation and what policies it will follow. Consequently, class voting in regard to public benefit corporations is only mandated for amendments that would change the rights of members to vote. Apart from amendments that would directly affect the right to vote, an amendment may indirectly affect the right to vote by terminating a class of members or amending the articles to add more members to an existing class of members or to create a new class of members.

Where, however, the amendment would

not affect the class in a manner different than it affects another class, class voting is not required. For example, if class A and class B each elected four directors, the proposal to have each class elect three directors normally would not affect either class differently and would not require class voting. However, if the articles required a vote of three class A directors to approve any action, a class vote would be required if the number of class A and class B directors were reduced by one.

Subsection (b) (§ 4-33-1004(b)) relates to mutual benefit corporations. Members in mutual benefit corporations, in addition to their voting rights, may have a valuable economic interest in the corporation. Consequently, subsection (b) (§ 4-33-1004(b)) specifies six types of changes that require a class vote. These changes are more extensive than the changes that would require a class vote in public benefit corporations and are designed to protect the rights of class members. See section 1.40(5) (§ 4-33-140(5)) for a definition of class.

Subsection (a) (§ 4-33-1004(a)) dealing with public benefit corporations and subsection (b) (§ 4-33-1004(b)) dealing with mutual benefit corporations require class

voting if certain changes are made. There is no requirement that the change adversely affect or directly or indirectly burden the class. If the amendment results in the specified changes, a class vote is required. Requiring a class vote for any change eliminates the subjective and sometimes difficult question of what is adverse and what is beneficial. If any of the specified changes occur, a class vote is required even if the board or members believe the change is advantageous or of no consequence.

The Model Act (§ 4-33-101 et seq.) does not require a class vote for members of a religious corporation. The articles or bylaws of a religious corporation may, however, require a class vote. See section 10.04(c) and (e) (§§ 4-33-1004(c) and (e)). A class vote is required for members of a religious corporation only and to the extent required by the corporation's articles or bylaws.

#### **Official Comment to Section 10.05 (A.C.A. § 4-33-1005)**

Section 10.05 (§ 4-33-1005) sets forth the contents of the articles of amendment that must be delivered to the secretary of state to effectuate an amendment to the articles of incorporation. The articles of amendment must specify that the conditions required for a valid amendment to be adopted have been met. In some non-profit corporations only the approximate vote in favor of an amendment is known. Therefore section 10.05 (§ 4-33-1005)

does not require that the exact vote be set forth in the articles of amendment. It does require that the approximate vote be set forth together with a statement that the number of votes cast for the amendment to the articles was sufficient for approval. Consequently, the person submitting the articles of amendment must be sure that the number of votes for the amendment at least meets the minimum vote required to approve the amendment.

#### **Official Comment to Section 10.06 (A.C.A. § 4-33-1006)**

Section 10.06 (§ 4-33-1006) allows a corporation to restate its articles of incorporation without a member vote. Such restated articles are often useful, particularly where numerous amendments have been adopted over a period of years.

Where the restated articles involve a change other than a change authorized by section 10.02(a) (§ 4-33-1002(a)), they should be submitted to the members, if any, for their approval.

In some instances, it may be necessary to make grammatical and other minor changes between the original articles and the restated articles of incorporation. In these instances, the restated articles of incorporation should be submitted to the members for their approval. This approval

may also require class voting and approval by third persons. See sections 10.04 and 10.30 (§ 4-33-1004 and 4-33-1030). Any such approval should follow the requirements of this chapter (§ 4-33-1001 et seq.) for approving amendments to articles of incorporation. The material seeking approval of the members should contain or be accompanied by a copy or summary restatement of the articles that identifies any amendments or other changes the restatement would make in the articles. While it is not necessary to restate matters that are, or may reasonably be viewed as, mere changes in form, other changes should be brought to the attention of the members.

#### **Official Comment to Section 10.07 (A.C.A. § 4-33-1007)**

Section 10.07 (§ 4-33-1007) is based on section 10.08 of the Model Business Corporation Act (§ 4-27-1008). Section 10.08 (§ 4-27-1008) "provides a simplified method of conforming corporate documents filed under state law with the fed-

eral statutes relating to corporate reorganization. If a federal court confirms a plan of reorganization that requires articles of amendment to be filed, those amendments may be prepared and filed by the persons designated by the court and the approval



of neither directors nor [members] is required.... This section only applies to amendments in articles of incorporation approved prior to the entry of a final

decree in the reorganization plan." Official Comment to Section 10.08 of the Model Business Corporation Act (§ 4-27-1008).

#### **Official Comment to Section 10.08 (A.C.A. § 4-33-1008)**

An amendment or restatement of the article does not affect an existing cause of action involving the corporation even if the amendment changes the corporate name. Moreover, an amendment does not affect any requirement or limitation imposed upon the corporation or any property held by it by virtue of any trust upon which such property is held by the corporation. If a public benefit or religious cor-

poration amends its articles to change its purposes, property held by the corporation immediately prior to the effective date of the amendment may remain subject to a limitation based on the prior articles or to restrictions imposed by the donor of the property.

Members may have contract or other legal rights that cannot be altered or eliminated by amendments to the articles.

#### **Official Comment to Section 10.20 (A.C.A. § 4-33-1020)**

Section 10.20 (§ 4-33-1020) allows directors in a corporation without members to amend the corporate bylaws subject to any approval required of third persons pursuant to section 10.30(1.30) (§ 4-33-1030). The section (§ 4-33-1020) also sets forth certain notice requirements that must be met to adopt an amendment to the bylaws.

If a corporation does not have members, its incorporators, until directors have

been chosen, may exercise the power of the directors in amending articles or bylaws. The incorporators must follow the rules applicable to directors.

Amendments may be adopted by incorporators or by the directors by unanimous written consent. See section 8.21 (§ 4-33-821). Notice of a directors' meeting may be waived pursuant to section 8.23 (§ 4-33-823).

#### **Official Comment to Section 10.21 (A.C.A. § 4-33-1021)**

Bylaws of nonprofit corporations, like bylaws of business corporations, govern and regulate the activities and affairs of the corporation. Bylaw provisions often parrot provisions of state statutes governing a myriad of matters from the corporate seal to voting and quorum requirements. They serve as a roadmap for members and directors who want to know what procedures to follow or what rules are applicable to the board or the members.

The bylaws of a nonprofit corporation serve an additional function that is not

analogous to the bylaws of a business corporation. The bylaws of a nonprofit corporation set forth the rights and duties of members. They are analogous to provisions of preferred stock which set forth the rights, privileges and preferences of preferred shareholders. As the basic rights of members are usually set forth in a nonprofit corporation's bylaws and not its articles, the Model Act (§ 4-33-101 et seq.) requires the same vote to amend bylaws as to amend articles. See Official Comment to Section 10.03 (§ 4-33-1003).

#### **Official Comment to Section 10.22 (A.C.A. § 4-33-1022)**

See Official Comment to Section 10.04 (§ 4-33-1004).

#### **Official Comment to Section 10.30 (A.C.A. § 4-33-1030)**

Section 10.30 (§ 4-33-1030) validates an article provision that requires a speci-

fied person or persons to approve changes in the articles or bylaws. Section 10.30

(§ 4-33-1030) provides flexibility in control over article and bylaw amendments by allowing parent or affiliated corporations, governmental bodies and others to exercise a veto power over such amendments. It also allows corporations with delegates to require that article or bylaw amendments be approved by the delegates. Due to the broad definition of the word "person" even a member or members may be given the right to disapprove an amendment to the articles or bylaws.

The Model Act (§ 4-33-101 et seq.) also provides that a person whose approval must be obtained to amend articles or bylaws must consent to a merger, or a sale of all, or substantially all, of the property of a corporation other than in the regular course of its activities. Sections 11.01, 11.03 and 12.02 (§§ 4-33-1101, 4-33-1103 and 4-33-1202).

### **Official Comment to Section 10.31 (A.C.A. § 4-33-1031)**

Section 10.31 (§ 4-33-1031) sets forth the procedures that must be followed to amend articles or bylaws to terminate all members or any class of members or redeem or cancel all memberships or any class of memberships. The procedures are in addition to the normal requirements for amending articles or bylaws and are required due to the extraordinary nature of the amendment. See section 1.40(5) (§ 4-33-140(5)) for the definition of "class."

Some public benefit corporations may decide that the benefits of having members are outweighed by the costs, possible harassment, or lack of contribution by members. If so, section 10.31 (§ 4-33-1031) provides a method of amending articles or bylaws to convert from a membership corporation to a corporation with a self-perpetuating board of directors. The board in proposing such an amendment must meet its fiduciary obligations under section 8.30 (§ 4-33-830). While there is no requirement that the board notify the members before it adopts such a resolution, some boards may wish to do so to avoid conflict and determine the attitude of members at an early stage. After adopting the proposed amendment, the board must wait twenty days before sending a notice to the members proposing the amendment. If during the twenty-day period a written statement of up to 500 words opposing the proposed amendment is submitted by any five members or members having three percent or more of the voting power, whichever is less, and the members pay the production and mailing costs of the statement, the board must mail the statement with the notice to members proposing the amendment. The board is only obligated to mail one state-

ment. If more than one statement is proposed, the board usually should use the statement presented by the most members.

An amendment proposing to convert from a membership corporation to a corporation with a self-perpetuating board has a different significance in a mutual benefit corporation. Mutual benefit corporations should operate for the benefit of their members. While there was considerable sentiment on the Committee to require mutual benefit corporations to have members, on balance it was believed that the disadvantages of such a rigid requirement outweighed its advantages. Once a mutual benefit corporation has members, the Committee believed that it should be required to provide the fullest and fairest forum possible before terminating those members. Therefore, mutual benefit corporations must inform their members of a proposed amendment to eliminate members or any class of members prior to the time the board adopts a resolution proposing such an amendment. In addition, the production and mailing costs of a statement in opposition submitted by members must be paid for by the corporation. Of course, if the terminated members have any contractual rights, these rights continue and are not terminated by the amendment. If the memberships in a mutual benefit corporation have some economic value, it is almost impossible for an amendment to terminate the members without providing adequate compensation. The result of an amendment terminating members would be to shift the economic benefits of the terminated members to the directors or some other person or persons. If the benefits were shifted to



the board, the directors would have an inherent conflict of interest in proposing an amendment to terminate the members. If the benefits were shifted to some other person, the board might not have a conflict of interest, but the members could still complain of the inherent unfairness.

The provisions of section 10.31 (§ 4-33-

1031) are not applicable to situations in which the board desires to terminate a certain person or a small group of persons without affording them their rights under sections 6.21 and 6.22 (§ 4-33-621 and 4-33-622). An amendment proposed for such a reason would breach the board's duties under section 8.30 (§ 4-33-830).

### **Official Comment to Section 11.01 (A.C.A. § 4-33-1101)\***

Chapter 11 (§ 4-33-1101 et seq.) authorizes mergers involving nonprofit corporations if specified conditions are met. In a merger one or more corporations merge and disappear into a surviving corporation. The surviving corporation continues and owns all the property of each party to the merger and is liable for the liabilities and obligations of each party to the merger. See sections 11.05 and 11.07 (§§ 4-33-1105 and 4-33-1107).

As it is usually more advantageous for one of the parties to a merger to survive, the Model Act (§ 4-33-101 et seq.) does not provide for "consolidations" in which all the parties merge and disappear into a new corporation. If two or more corporations desire to merge their activities, but do not desire to continue one of the existing corporations, a new corporation can be incorporated and the existing corporations merged into it. By following this approach a "consolidation" of existing corporations can be achieved.

The Model Act (§ 4-33-101 et seq.) does not provide for dissenters' rights. As members of a public benefit or religious corporation have no economic interest in their corporation they cannot be given cash as the result of a merger. Therefore they cannot have dissenters' rights. While members of a mutual benefit corporation may have an economic interest in their corporation, the concept of dissenters' rights seems inappropriate in the nonprofit context. While memberships in mutual benefit corporations may be valuable, most memberships do not represent an investment that will generate a profit on their sale. Consequently it is inappropriate to give a member an automatic right to

cash by exercising dissenters' rights and in effect "selling" a membership.

A member of a nonprofit corporation may file a proceeding to enjoin or rescind a merger. A member of a mutual benefit corporation may also sue for damages. Where the provisions of this chapter (§ 4-33-1101 et seq.) have been complied with and the board has met its statutory duties of care and loyalty, a court should uphold a merger. Where a merger is improperly approved, the Model Act (§ 4-33-101 et seq.) does not specify the remedy, if any. A court may consider all relevant facts including the good faith of the parties, the fairness of the merger, the effect of the merger, the nature of any omission or misstatement of fact, whether the failure to comply with the provisions of this chapter (§ 4-33-1101 et seq.) was serious and substantive or technical and unimportant, the reasons and need for the merger, and whether the merger would have been approved in any event. After considering all relevant facts a court may rescind the merger, order the payment of damages or other remedy or find that a remedy is inappropriate and uphold a merger even though the provisions of this chapter (§ 4-33-1101 et seq.) have not been met.

The Model Act (§ 4-33-101 et seq.) does not authorize short form mergers or the nonprofit equivalent of a reorganization by share exchange. These procedures are appropriate in the business, but not the nonprofit, context.

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 11.02 (A.C.A. § 4-33-1102)\***

The provisions of section 11.02 (§ 4-33-1102) are designed to prevent the assets of

public benefit or religious corporations from being diverted from their intended

charitable or public purposes as a result of a merger. Consequently section 11.02 (§ 4-33-1102) provides that public benefit and religious corporations can merge only under specified conditions with specified types of corporations without court approval in a proceeding in which the attorney general has been given written notice. In addition, members of public benefit and religious corporations may only receive or keep memberships in the surviving corporation unless they obtain court or attorney general approval.

If the requirements of section 11.02(a)(4) (not enacted by Arkansas) are met, a public benefit or religious corporation may merge with a business or mutual benefit corporation that is the surviving entity. However, those in control of the public benefit or religious corporation may not enter into a sweetheart merger in which they acquire the assets of the corporation for less than its fair market value. Two requirements of subsection (a)(4) (not enacted by Arkansas) address this problem. The first is that the fair market value of the public benefit or religious corporation must be established and paid for the assets of the corporation. Fair market value is defined as the greater of the value of the net tangible and intangible assets (including goodwill) of the public benefit corporation or its value if it were an ongoing business concern. These figures could be different. A public benefit or religious corporation might have a small net worth, but significant earning potential if it were operated as a business corporation. Consequently the ongoing concern value would be higher than the net asset value. To avoid any dispute, the Model Act (§ 4-33-101 et seq.) requires that the higher "value" be paid for the corporation.

The second requirement deals with the fact that value is often subjective and difficult to determine. Subdivision (a)(4) (iii) (not enacted by Arkansas) requires that the merger must be approved by a majority of the public benefit or religious corporation's directors who will not be shareholders in or officers, employees, agents or consultants of the surviving

corporation. This diminishes a possible conflict of interest with the attendant pressure on the directors to value the public benefit or religious corporation at less than its true fair market value.

Apart from the specific limitations of subdivision (a)(4) (not enacted by Arkansas), the directors and officers must meet their duties of care and loyalty under sections 8.30, 8.31 and 8.40 (§§ 4-33-830, 4-33-831 and 4-33-840). They must determine that the merger is in the best interest of the public benefit corporation. Moreover the directors and offices cannot engage in any side deals or receive any incentives to favor or not to object to the merger if the incentives violate their duty of loyalty.

Once the value of the public benefit or religious corporation has been determined, that value must be transferred to an appropriate entity. The distributee must be an entity or entities that would have received the assets under section 14.06(a)(5) and (6) (§ 4-33-1406(a)(5) and (6)) had the corporation dissolved. See the Official Comment to Section 14.06 (§ 4-33-1406). Any assets held upon condition requiring return, transfer or conveyance, which condition occurs by reason of the merger, must be returned in accordance with such condition. See section 14.06(a)(4) (§ 4-33-1406(a)(4)) and Official Comment to Section 14.06 (§ 4-33-1406).

A court in approving a merger may allow members of a public benefit or religious corporation to receive something of value only if it is in the public interest for them to do so. For example, the members may invest in a business corporation that is the surviving corporation in a merger with the public benefit corporation. A court should closely scrutinize the merger to make sure the conditions of section 11.02 (§ 4-33-1102) have been met. In addition, it must find that the merger is in the public interest.

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\*The version of this section enacted by Arkansas differs from the Model Act.



**Official Comment to Section 11.03 (A.C.A. § 4-33-1103)**

Section 11.03 (§ 4-33-1103) sets forth the requirements for approving a merger.

If a corporation does not have members, unless the Model Act (§ 4-33-101 et seq.), the articles or bylaws require a greater vote, the plan of merger must be approved by a majority of the directors in office at the time the merger is approved. While it is usually not necessary to give directors notice of matters that will be considered at directors' meetings, subdivision (b)(4) (§ 4-33-1103 (b)(4)) requires that corporations without members not only notify the directors of the meeting but that the notice indicate that one of the matters to be considered at the meeting is the proposed merger.

If a corporation has members, the board must adopt the plan of merger and submit it to the members for their approval. Unless the Model Act (§ 4-33-101 et seq.), the articles or bylaws require a greater vote or voting by class, voting by class is required if the plan contains a provision that would require a class vote if it were contained in amendment to the articles or bylaws. The members must approve the plan of merger by a two-thirds vote of the votes cast or a majority of the voting power, whichever is less. The affirmative votes must also constitute a majority of the required quorum. See section 1.40(1) (§ 4-33-140(1)). Class voting is required if the plan contains a provision that would require a class vote if it were contained in a bylaw or article amendment.

The notice of the meeting or material soliciting the approval must set forth the material facts concerning the merger. For example, if the members of the surviving corporation become subject to an article or bylaw provision that would normally require a vote of the members, they must be

given a copy or summary of the provision prior to voting on the proposed merger. See subsections 12.03(d) and (e) (§ 4-33-1203(d) and (e)). Members of the disappearing corporation must receive a copy or summary of the complete articles and bylaws of the surviving corporation prior to voting on the merger. See subsections 12.03(d) and (e) (§ 4-33-1203(d) and (e)). Members of the disappearing corporation are entitled to the additional material because they were not subject to the articles and bylaws of the surviving corporation prior to the merger.

If a plan of merger contains a provision that, if contained in an amendment to articles or bylaws, would entitle members of that class to vote as a class, the merger is not approved unless it is approved by that class of members. Each class entitled to vote must approve the plan by two-thirds of the votes cast or a majority of the voting power of the class, whichever is less. The affirmative votes also must constitute a majority of the required quorum. See section 1.40(1) (§ 4-33-140(1)).

To provide flexibility, subsection (c) (§ 4-33-1103 (c)) allows the board or the members in approving the merger to condition approval of the merger upon its receiving a higher percent of votes than would normally be required or on any other basis.

If the consent of a person is required pursuant to section 10.30 (§ 4-33-1030) to approve an amendment to the articles or bylaws of a constituent corporation, that person's consent is also needed to approve a plan of merger. This requirement prevents the corporation from eliminating the person's right to approve an amendment by merging with a wholly owned subsidiary.

**Official Comment to Section 11.04 (A.C.A. § 4-33-1104)**

Upon filing the articles of merger with the secretary of state, the transaction becomes a matter of public record as the articles of merger set forth the plan of merger. A merger becomes effective when

the articles of merger are filed with the secretary of state unless a delayed effective date is requested. See section 1.23 (§ 4-33-123).

**Official Comment to Section 11.05 (A.C.A. § 4-33-1105)**

Section 11.05 (§ 4-33-1105) sets forth the legal effects of a merger. On the effective date of the merger the disappearing corporation merges and disappears into the surviving corporation. The surviving corporation owns all the property owned by each constituent corporation and is liable for all liabilities and obligations (contingent or otherwise) of each constituent corporation. Trust obligations on property of a disappearing corporation are limited to the property affected thereby

immediately prior to the time the merger is effective. If the surviving corporation receives property that would have gone to a disappearing corporation, the property is subject to the same restrictions that would have applied had the property been received by the disappearing corporation. Where the property is given on the condition that it be used for specified purposes, that condition is not removed as a result of the merger. See section 11.07 (§ 4-33-1107).

**Official Comment to Section 11.06 (A.C.A. § 4-33-1106)\***

Section 11.06 (§ 4-33-1106) authorizes foreign nonprofit and business corporations to merge with nonprofit corporations if there is an applicable law in their respective states of incorporation and the law's provisions are met. Of course, the provisions of the Model Act (§ 4-33-101 et seq.) must also be complied with in carrying out the merger.

If the surviving corporation is a foreign corporation, the merger results in its irre-

vocably appointing the secretary of state as its agent for service of process in any proceeding brought against it. This appointment is not limited to matters arising out of or relating to the merger, but applies to any and all claims that might be made against the foreign corporation.

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\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 11.07 (A.C.A. § 4-33-1107)**

Bequests, devises, gifts and grants to a disappearing corporation that take effect or remain payable after a merger inure to the benefit of the surviving corporation in a merger. Where, however, the will or other instrument otherwise specifically provides, the specific provision will control.

A provision in a will or other instrument requiring that a bequest or gift be used for a specified purpose is not negated by a merger even if the surviving corporation is not engaged in the same activities as the disappearing corporation. It can only

use the property for the specified purposes. If the surviving corporation cannot or does not want to use the bequest or gift for the purposes specified, it must seek court approval for a variance. The question of whether a variance will be granted is left to the cypres doctrine or other applicable state law.

Section 11.07 (§ 4-33-1107) only applies to bequests, devises, gifts and grants that take effect or remain payable after a merger. Section 11.05 (§ 4-33-1105) applies to transfers that take effect prior to the merger.

**Official Comment to Section 12.01 (A.C.A. § 4-33-1201)**

Section 12.01 (§ 4-33-1201) deals with two types of transactions. In the first type a nonprofit corporation sells or otherwise disposes of all, or substantially all, of its property in the usual and regular course of its activities. While such a sale or disposition would normally not be in the regular course of its activities, if it is, it may be approved by the board alone un-

less the articles require approval of the members or some other person.

The second type of transaction is one in which a nonprofit corporation mortgages, pledges or dedicates to the repayment of indebtedness any or all of its property whether or not in the usual and regular course of its activities. This type of transaction would normally arise when a bank



or some other lender requires a corporation to pledge its property as collateral for a loan. Subject to a contrary provision in a corporation's articles, such a mortgage, pledge or dedication can be authorized by the board alone.

The question of what is "substantially all" of a corporation's property is a factual question to be determined after an examination of all relevant facts. "The phrase 'substantially all' is synonymous with 'nearly all' and was added merely to make it clear that the statutory requirements could not be avoided by retention of some minimal or nominal residue of the original assets. A sale of all the corporate assets other than cash or cash equivalents is

normally the sale of 'all or substantially all' of the corporation's property." Official Comment to Section 12.01 of the Model Business Corporation Act (§ 4-27-1201). Moreover, a series of related transactions that in total amount to the sale of all, or substantially all, of a corporation's property may be treated as a single transaction if they are part of an overall plan to dispose of all, or substantially all, of the corporation's property.

The board in approving a transaction under section 12.01 (§ 4-33-1201) must meet its fiduciary obligations under sections 8.30 and 8.31 (§§ 4-33-830 and 4-33-831).

#### **Official Comment to Section 12.02 (A.C.A. § 4-33-1202)\***

A sale or other disposition of all, or substantially all, of a corporation's property other than in the usual and regular course of its activities must meet the requirements set forth in section 12.02 (§ 4-33-1202). See the Official Comment to Section 12.01 (§ 4-33-1201) for a discussion of the meaning of the phrase "all or substantially all." The notice requirements are similar to the approval and notice requirements for a merger. See the Official Comment to Section 11.03 (§ 4-33-1103).

Unless the resolution proposing the transaction provides to the contrary, the board acting alone may abandon a sale or other disposition of property after the transaction has been authorized. The abandonment, however, does not negate contractual rights of third persons.

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\*The version of this section enacted by Arkansas differs from the Model Act.

#### **Official Comment to Section 13.01 (A.C.A. § 4-33-1301)**

Section 13.01 (§ 4-33-1301) sets forth the basic rule that a corporation is prohibited from making any distributions. The term "distributions" is defined in section 1.40(10) (§ 4-33-140(11)) as the "payment of a dividend or of any part of the income or profit of a corporation to its members, directors or officers." See Official Comment to Section 1.40, Comment § (§ 4-33-140).

Section 13.01 (§ 4-33-1301) does not prohibit the transfer of property to members of nonprofit corporations under any and all circumstances. However, the prohibition on payment of dividends is quite broad. If a transfer is a direct payment to a member as a result of his or her interest in the nonprofit corporation, it is prohibited. Cash dividends from whatever source are the clearest example of prohib-

ited dividends. See *Kubik v. American Alliance, Inc.*, 54 N.Y.S.2d 764 (1945).

The question arises as to what a corporation can do with profits it generates as it cannot use the profits to pay dividends. Public benefit and religious corporations typically use profits to further their public, charitable or religious purposes. Mutual benefit corporations usually use profits to improve their facilities and services. In *Burton Potter Post No. 185, American Legion v. Epstein*, 219 N.Y.S.2d 224 (1961), a nonprofit club generated profits from its activities. The funds were used to improve the club facilities. The court found that the corporation was "not organized for pecuniary profit as long as it devotes its income to club purposes." *Id.* at 227.

While the members benefit from the use of funds for club purposes, that benefit is

not a dividend and is not considered a distribution because the corporation is conferring benefits upon its members in conformity with its purposes.

A payment that is not derived from "any part of the income or profit of a corpora-

tion to its members, directors or officers" is not a distribution. Thus the return of an overcharge or the providing of services for which members have paid is not a distribution. Nor is the payment of reasonable compensation for services rendered.

### Official Comment to Section 13.02 (A.C.A. § 4-33-1302)

Section 13.02(a) (§ 4-33-1302(a)) is new, but is not inconsistent with section 26 of the prior version of the Model Nonprofit Corporation Act. It is based in part on section 6.40 of the Model Business Corporation Act (§ 4-27-640). Section 13.02(b) (§ 4-33-1302 (b)) is based upon and represents no substantive change from section 26.

#### 1. *Purchase of Memberships*

Mutual benefit corporations may purchase their memberships if the two tests of section 13.02(a) (§ 4-33-1302(a)) are met. Each test is designed to protect creditors.

The first test is that after the purchase of a membership the corporation "would be able to pay its debts as they become due in the usual course of its activities." Section 13.02(a)(1) (§ 4-33-1302 (a)(1)). A determination of whether this test is met requires the directors to form "a conclusion that known obligations of the corporation can reasonably be expected to be satisfied over the period of time that they will mature. It is not sufficient simply to measure current assets against current liabilities, or determine that the present estimated 'liquidation' value of the corporation's assets would produce sufficient funds to satisfy the corporation's existing liabilities." Official Comment to Section 6.40 of the Model Business Corporation Act (§ 4-27-640).

In determining whether the first test is met the directors must exercise their duty of care under section 8.30 (§ 4-33-830), and are entitled to rely on information or reports they receive. See section 8.30(b) (§ 4-33-830(b)).

The second test requires that after the purchase of a membership the corporation's "total assets would at least equal the sum of its total liabilities." Section 13.02(a)(2) (§ 4-33-1302 (a)(2)). If the corporation uses generally accepted accounting principles and the directors rely on corporate officers or accountants under section 8.30(b) (§ 4-33-830(b)), it should be easy to determine if the second test is met. If generally accepted accounting principles are not used, the corporation should use practices and principles that are reasonable under the circumstances.

#### 2. *Payments Upon Dissolution*

Section 13.02 (§ 4-33-1302) allows public benefit, mutual benefit and religious corporations to make distributions to their members if the provision of Chapter 14 (§ 4-33-1401 et seq.) are met.

Chapter 14 (§ 4-33-1401 et seq.) sets forth provisions governing the disposition of assets upon dissolution. Normally the members of a mutual benefit corporation will receive its "net worth" upon dissolution. Members of a public benefit or religious corporation normally will not share in its "net worth" upon dissolution. This is because they do not have any economic interest in its assets. However, under the very limited circumstances set forth in section 14.06 (§ 4-33-1406), a public benefit or religious corporation may distribute its assets to its members if those members are recognized as exempt under section 501(c)(3) of the Internal Revenue Code or its members are themselves public benefit or religious corporations.

### Official Comment to Section 14.01 (A.C.A. § 4-33-1401)

Section 14.01 (§ 4-33-1401) allows a majority of the incorporators or directors of corporations that have no members to dissolve the corporation by delivering articles of dissolution to the secretary of

state. See section 14.04 (§ 4-33-1404) which specifies the information that must be contained in articles of dissolution.

When approving dissolution, the incorporators or directors must adopt a plan of



dissolution indicating to whom the assets owned or held by the corporation will be distributed after creditors have been paid. This requirement allows corporate assets to be traced to the individuals or entities to whom they have been distributed. A record that is sufficient to satisfy this purpose will meet the requirements of section 14.01(c) (§ 4-33-1401(c)).

Section 14.01 (§ 4-33-1401) requires a majority of the incorporators or directors to vote for dissolution, not just a majority of a quorum. This higher-than-normal vote is required because dissolution is a

basic corporate change. The articles, bylaws or some other state law may require an even higher vote or approval of a third person or governmental entity. See sections 1401(a) and 8.24 (§ 4-33-1401(a) and 4-33-824).

As dissolution is a fundamental corporate change, subsection (b) (§ 4-33-1401(b)) requires the corporation to notify each director or incorporator of a meeting at which dissolution will be approved. The notice must state that dissolution will be considered at the meeting.

### **Official Comment to Section 14.02 (A.C.A. § 4-33-1402)**

Section 14.02 (§ 4-33-1402) allows the board to propose and the members to authorize dissolution of a nonprofit corporation. The board in proposing dissolution must submit a plan of dissolution to the members. The plan must indicate to whom the assets owned or held by the corporation will be distributed after creditors have been paid. If the assets will be distributed to the members, it should be sufficient to so indicate without setting forth the name of each member. If the board has determined that assets will be distributed to other organizations and the names of the organizations are known, the names should be specified. If the board has discretion in distributing the assets, the board should indicate that the assets shall be distributed to such individuals and entities as it subsequently decides.

In seeking member approval, the board must give written notice of a membership meeting pursuant to section 7.05 (§ 4-33-705) and indicate that dissolution will be considered at the meeting. In the alternative, the board may seek member approval

by written consent pursuant to section 7.04 (§ 4-33-704) or written ballot pursuant to section 7.08 (§ 4-33-708). If approval by written consent or written ballot is sought, the material soliciting the approval must contain or be accompanied by a copy or summary of the plan of dissolution.

Approval of dissolution at a membership meeting normally requires two-thirds of the votes cast or a majority of the voting power, whichever is less. The articles, bylaws, board or members may require a greater vote or voting by class. If approval is sought by written consent pursuant to section 7.04 (§ 4-33-704) or written ballot pursuant to section 7.08 (§ 4-33-708), any additional requirements of those sections must be met.

Public benefit corporations must give the attorney general the written notice required by section 14.03(a). The attorney general is authorized to take appropriate action to protect the public interest and assets held in trust. See section 1.70 (not enacted by Arkansas).

### **Official Comment to Section 14.03\***

Section 14.03 requires public benefit and religious corporations to give the attorney general written notice that they intend to dissolve at the same time as or before delivering articles of dissolution to the secretary of state. The notice must include a copy or summary of the plan of dissolution. The corporation may not transfer any assets as part of the dissolution process until twenty days after it has given this notice to the attorney general.

The attorney general may waive this twenty-day period by consenting in writing to the dissolution or indicating in writing that he or she will take no action in respect to the transfer. The prohibition on transfers applies only to transfers made as part of the dissolution process. Transfers in the regular course of a corporation's activities are not affected by the notice requirement of section 14.03.

Subsection (c) requires the board of a

public benefit corporation to deliver to the attorney general a list of those to whom the corporate assets have been transferred. The list must show the name and address of each person (other than creditors) who received assets and state what assets each received. The list must be given to the attorney general when substantially all of the assets have been

transferred. This list provides a record should there be a question as to the propriety of any transfer. No such requirement is imposed on mutual benefit or religious corporations.

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\*This section was not enacted by Arkansas.

#### **Official Comment to Section 14.04 (A.C.A. § 4-33-1404)**

Unless the articles of dissolution specify a later effective date a corporation is dissolved upon filing articles of dissolution with the secretary of state. Thereafter the corporation is a "dissolved corporation," although its corporate existence continues for purposes of winding up under section 14.06 (§ 4-33-1406).

The articles of dissolution may be filed at any time after dissolution is autho-

rized. A corporation may file articles of dissolution immediately after dissolution is authorized so that dissolution becomes a matter of public record. Alternatively, it may wait and file articles at or near the end of the winding up process. After dissolution is authorized, the corporation may commence the winding up process even though it has not filed the articles of dissolution.

#### **Official Comment to Section 14.05\***

Section 14.05 allows the corporation to revoke dissolution within 120 days after its effective date. Normally revocation must be authorized in the same manner as the dissolution was authorized. Consequently if member or third person approval was required for dissolution, member or third person approval is required for revocation. Where, however, those authorizing the dissolution authorize the directors acting alone to revoke the dissolution, the directors may revoke the dissolution without the consent of any other person.

Dissolution is revoked when the corporation delivers articles of revocation of dissolution together with a copy of its articles of dissolution to the secretary of state. The winding up process ceases upon filing the articles of revocation of dissolution; the corporation is no longer a "dissolved corporation," and normal corporate activities recommence.

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\*This section was not enacted by Arkansas.

#### **Official Comment to Section 14.06 (A.C.A. § 4-33-1406)**

Section 14.06 (§ 4-33-1406) spells out the effect of filing articles of dissolution. A corporation is a "dissolved corporation" after it has filed articles of dissolution. It continues its existence, but may only carry on activities necessary or desirable to wind up and liquidate its affairs. Subsection (a) (§ 4-33-1406(a)) spells out some, but not all, of the activities in which a dissolved corporation may engage.

In general, the corporation is charged with preserving and protecting its assets and discharging or making provision for discharging its liabilities and obligations. In some instances it may not be possible

or desirable to discharge obligations immediately. For example, if a debt is due over a period of time it may be desirable to set up a fund that will pay the debt as it matures. When all corporate debts and obligations have been discharged or adequately provided for, a nonprofit corporation may dispose of its remaining assets in an orderly fashion.

If it holds assets on a condition requiring their return, the assets must be returned pursuant to the condition. For example, some charities hold assets that they may use so long as they operate. Upon dissolution these charities may have



to return the assets to their donor or transfer the assets to another charity.

Where a corporation has an article or bylaw specifying the distribution of assets upon dissolution, that article or bylaw should be followed subject to any legal or contractual limitations.

All nonprofit corporations formed under the present version of the Model Act (§ 4-33-101 et seq.) are required to indicate in their articles how their assets will be distributed upon dissolution. See section 2.02(a)(7) (§ 4-33-202(a)(7)). However, the articles may simply authorize the board to distribute the assets to an organization recognized as exempt under section 501(c)(3) of the Internal Revenue Code. The articles may not specify the particular organization that is to receive the assets, but leave the ultimate decision to the discretion of the board. The articles and bylaws of nonprofit organizations formed before the present version of the Model Act (§ 4-33-101 et seq.) and may not specify the disposition of assets upon dissolution.

Where there is no article or bylaw provision specifying to whom assets should be distributed upon dissolution, section 14.06 (§ 4-33-1406) distinguishes among public benefit, mutual benefit and religious corporations. For public benefit and religious corporations section 14.06(a)(6) (§ 4-33-1406(a)(6)) requires assets to be distributed to one or more persons described in section 501(c)(3) of the Internal Revenue Code or, if the dissolved corporation is not described in section 501(c)(3), to one or more public benefit or religious corporations. In no event may the assets be distributed to members of a public benefit or religious corporation unless they are entities authorized to receive assets by section 14.06 (§ 4-33-1406). They might, for example, be recognized as exempt under section 501(c)(3) of the Internal Revenue Code. All distributions are

subject to contractual and other legal requirements upon the corporation.

The limitations on distributions by public benefit and religious corporations are essential elements of the nondistribution constraint. It assures that the assets of a public benefit or religious corporation cannot be accumulated and then distributed for the private benefit of members upon the corporation's dissolution.

While members of a mutual benefit corporation are not entitled to distributions while their corporation is operating, they may receive corporate assets upon dissolution. Consequently, if no provision has been made in a mutual benefit corporation's articles or bylaws for distribution of assets on dissolution, section 14.06(a)(7) (§ 4-33-1406(a)(7)) provides that the assets shall be distributed to its members. (Contractual or other legal requirements may prevent the members from receiving the assets.) In those rare instances in which the articles or bylaws do not specify the individuals to whom the assets of a mutual benefit corporation will be distributed and the mutual benefit corporation has no members, the assets should be distributed to those persons whom the corporation holds itself out as benefitting or serving. While this may present some practical problems, these problems can be avoided by amending the articles or bylaws prior to dissolution to specify the individuals or entities to whom the assets will be distributed upon dissolution. The directors must meet their duties under sections 8.30 and 8.31 (§§ 4-33-830 and 4-33-831) in adopting any such article or bylaw provision.

As a result of section 14.06(b) (§ 4-33-1406(b)) the rights, powers and obligations of the directors and members of a dissolved corporation do not change during the winding up process and suits involving the corporation are not affected by the dissolution.

### Official Comment to Section 14.07 (A.C.A. § 4-33-1407)

"Section 14.0[7] and 14.0[8] provide a new and simplified system for handling known and unknown claims against a dissolved corporation, including claims based on events that occur after the dissolution of the corporation. Section 14.0[7] deals solely with known claims while sec-

tion 14.0[8] deals with unknown or subsequently arising claims. A claim is a 'known' claim even if this is unliquidated (see section 14.0[7](d)); a claim that is contingent or has not matured so that there is no immediate right to bring suit is not a 'known' claim.

"Known claims are handled in section 14.0[7] through a process of written notice to claimants; the written notice must contain the information described in section 14.0[7](b). Section 14.0[7](c) then provides fixed deadlines by which claims are barred under various circumstances, as follows:

(1) If a claimant receives written notice satisfying section 14.0[7](b) but fails to file the claim by the deadline specified by the corporation, the claim is barred by section 14.0[7](c)(1).

(2) If a claimant receives written notice satisfying section 14.0[7](b) and files the claim as required:

(i) if the corporation rejects the claim, the claimant must commence a proceeding to enforce the claim within the 90 days of the rejection or the claim is barred by section 14.0[7](c)(2); or

(ii) if the corporation does not act on the claim or fails to notify the claimant

of the rejection, the claimant is not barred by section 14.0[7](c) until the corporation notifies the claimant.

(3) If the corporation publishes notice under section 14.0[8], a claimant who was not notified in writing is barred unless he commences a proceeding within five years after publication of the notice.

(4) If the corporation does not publish notice, a claimant who was not notified in writing is not barred by section 14.0[7](c) from pursuing his claim.

"These principles, it should be emphasized, do not lengthen statutes of limitation applicable under general state law. Thus claims that are not barred under the foregoing rule—for example, if the corporation does not act on a claim—will nevertheless be subject to the general statute of limitations applicable to claims of that type." Official Comment to Section 14.06 of the Model Business Corporation Act (§ 4-27-1406).

#### Official Comment to Section 14.08 (A.C.A. § 4-33-1408)\*

"Earlier versions of the Model Act did not recognize the serious problem created by possible claims that might arise long after the dissolution process was completed and the corporate assets distributed to [members] ...

The solution adopted in section 14.0[8] is to continue the liability of a dissolved corporation for subsequent claims for a period of five years after it publishes notice of dissolution. It is recognized that a five year cut-off is itself arbitrary, but it is believed that the great bulk of post dissolution claims will arise during this period. This provision is therefore believed to be a reasonable compromise between the competing considerations of providing a remedy to injured plaintiffs and providing a period of repose after which dissolved corporations may distribute remaining assets free of all claims....

Directors must generally discharge or make provision for discharging all of the corporation's liabilities before distributing the remaining assets.... But section 14.0[8] does not contemplate that liquidating distributions .... will be deferred until all possible claims are barred under section 14.0[8]. Many claims covered by this section are of a type for which provi-

sion may be made by the purchase of insurance or by the setting aside of a portion of the assets, thereby permitting prompt distributions in liquidation. Claimants, of course, may always have recourse to the remaining assets of the dissolved corporation. See section 14.0[8](d)(1). Further, where unexpected claims arise after distributions have been made to [persons other than creditors] in liquidation, section 14.0[8](d)(2) authorizes recovery against the [persons] receiving the earlier distributions. The recovery, however, is limited to the smaller of the recipient [member's] pro rata share of the claim or the total amount of assets received as liquidating distributions by the [member] from the corporation. The provision ensures that claimants seeking to recover distributions from [members] will try to recover from the entire class of [members] rather than concentrating only on the larger [members]...." Official Comment to Section 14.07 of the Model Business Corporation Act (§ 4-27-1407).

\*The version of this section enacted by Arkansas differs from the Model Act.



**Official Comment to Section 14.20 (A.C.A. § 4-33-1420)\***

Section 14.20 (§ 4-33-1420) sets forth the limited circumstances in which a non-profit organization may be dissolved administratively. The secretary of state is authorized but is not required to commence dissolution proceedings for the reasons set forth in section 14.20 (§ 4-33-1420). The secretary of state may commence the proceedings immediately or may give additional notices or time to the offending corporation. An administrative dissolution saves the time, money, and effort that might otherwise be required for a judicial dissolution. This is particularly important in the nonprofit area as numerous corporations with insignificant funds may fade into oblivion with-

out any responsible person following the formalities required for a voluntary dissolution. The notice provisions of section 14.21 (§ 4-33-1421) are designed to give the offending corporation an opportunity to avoid dissolution. Where, however, the corporation has been administratively dissolved it still has two years to be reinstated. See section 14.22 (§ 4-33-1422).

When a corporation has been administratively dissolved, its corporate name is available for use by other corporations.

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\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 14.21 (A.C.A. § 4-33-1421)\***

Section 14.21 (§ 4-33-1421) requires the secretary of state to give corporations 60 days' notice before it is administratively dissolved for one of the reasons set forth in section 14.20 (§ 4-33-1420). During this time the corporation has an opportunity to correct the failure and avoid administrative dissolution. If the corporation does not respond within the 60-day period, the secretary of state may dissolve

the corporation. The corporation will be sent notice of the dissolution and have an opportunity to reinstate its corporate status within two years after the effective date of the dissolution. See section 14.22 (§ 4-33-1422).

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\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 14.22 (A.C.A. § 4-33-1422)\***

Section 14.22 (§ 4-33-1422) provides a two-year period after the effective date of an administrative dissolution to apply to the secretary of state for reinstatement. No court proceeding is needed. The secretary of state may cancel the dissolution and prepare a certificate of reinstatement that relates back to the effective date of the administrative dissolution. The secretary of state should issue the certificate of

reinstatement if the application for reinstatement meets the requirements set forth in section 14.22 (§ 4-33-1422). If the secretary of state refuses to reinstate the corporation an appeal may be taken under section 14.23 (§ 4-33-1423).

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\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 14.23 (A.C.A. § 4-33-1423)\***

Section 14.23 (§ 4-33-1423) allows a corporation that has been administratively dissolved to appeal the secretary of state's denial of reinstatement. States adopting this Model Act (§ 4-33-101 et seq.) should indicate which court will have jurisdiction over the appeal, which party

has the burden of proof on appeal, and a standard for judicial review. See Official Comment to Section 1.26 (§ 4-33-126).

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\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 14.30 (A.C.A. § 4-33-1430)\***

Section 14.30 (§ 4-33-1430) specifies the people who can seek a court-ordered dissolution and the grounds for dissolution. A court has wide discretion in determining whether dissolution will be granted and may refuse to order dissolution even if it finds that the grounds for dissolution are present. Before ordering dissolution a court must consider the matters set forth in subdivision (b) (§ 4-33-1430(b)).

**1. Involuntary Dissolution by State**

Section 14.30 (§ 4-33-1430) preserves the right of the state to file a proceeding to involuntarily dissolve a corporation. The attorney general has the duty of protecting the public interest. This duty is particularly important in regard to public benefit corporations. The attorney general must determine whether there is unfairness or fraud in regard to the public, whether the corporation is carrying out its legitimate purposes, or whether assets are being diverted to the personal benefit of officers, directors, members, or controlling persons.

Members of mutual benefit corporations are more likely to protect their own interests than members of public benefit corporations. In addition, mutual benefit corporations do not hold themselves out as operating for the public good. Therefore, the attorney general's oversight role in regard to these corporations is less than in regard to public benefit corporations. Consequently, subsection (a) (§ 4-33-1430(a)) draws a distinction between public benefit and mutual benefit corporations and gives the attorney general and courts greater leeway in regard to public benefit corporations.

The attorney general can use subdivision (a)(1) (§ 4-33-1430(a)(1)) to test the legality of any actions the corporation has taken or intends to take. This duty has been shifted to the attorney general and away from the secretary of state who has limited authority in regard to filing articles. See Official Comment to Section 1.25 (§ 4-33-125).

**2. Involuntary Dissolution by Members, a Director, or a Person Specified in a Corporation's Articles**

Subdivision (a)(2) (§ 4-33-1430(a)(2)) allows fifty members or members who

hold 5% of the voting power, whichever is less, a director, or any person specified in the corporation's articles to bring a proceeding for involuntary dissolution of the corporation. The articles or bylaws of a religious corporation may prevent members or directors from bringing an action to dissolve the corporation. Subdivision (a)(2) (§ 4-33-1430(a)(2)) sets forth the grounds upon which a court may order dissolution. In determining whether to grant dissolution a court should act with caution. In the case of public benefit corporations the primary matter of concern is the public or charitable purposes of the corporation. In the case of mutual benefit corporations the main consideration is whether the corporation can be operated for the benefit of its members. Courts should be particularly cautious in the case of religious corporations not to order dissolution if there is an appropriate alternative.

**3. Dissolution by Creditors**

Creditors can bring a proceeding for dissolution only if the grounds specified in subdivision (a)(3) (§ 4-33-1430(a)(3)) have been met. Creditors may seek dissolution as an alternative to a federal bankruptcy proceeding.

**4. Dissolution by Corporation**

A corporation that has commenced a voluntary dissolution proceeding may seek protection in a court-supervised dissolution proceeding under subdivision (a)(4) (§ 4-33-1430(a)(4)). The directors of the corporation may be concerned with personal liability or may face numerous suits or other actions that should be dealt with in one court-supervised dissolution proceeding.

**5. Factors To Be Considered by Court Before Ordering Dissolution**

Subsection (b) (§ 4-33-1430(b)) sets forth matters that a court should consider before ordering dissolution. As dissolution is a remedy of the last resort, a court should consider reasonable alternatives. For example, if the directors are misapplying or wasting corporate assets, the court may give the directors an opportunity to resign or, if the requirements of section 8.10 (§ 4-33-810) have been met, may remove the offending directors. In



the case of a public benefit corporation the court should attempt to fashion a remedy that is in the public interest. In the case of a mutual benefit corporation the remedy should be the best way of protecting the interests of members.

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 14.31 (A.C.A. § 4-33-1431)**

Section 14.31 (§ 4-33-1431) sets forth procedures to be followed in a judicial dissolution. States adopting this Model Act (§ 4-33-101 et seq.) should determine

the place where venue lies for proceedings brought by the attorney general to dissolve a corporation.

### **Official Comment to Section 14.32 (A.C.A. § 4-33-1432)**

Section 14.32 (§ 4-33-1432) authorizes a court to appoint a receiver or custodian in a judicial dissolution proceeding involving a public benefit or mutual benefit corporation. Section 14.32 (§ 4-33-1432)

is designed to supplement provisions found in most states dealing with the power of courts to appoint receivers and custodians.

### **Official Comment to Section 14.33 (A.C.A. § 4-33-1433)**

Section 14.33 (§ 4-33-1433) provides that the court order dissolving a corporation shall be filed with the secretary of state. The filing of the order of dissolution has the same effect as the filing of the articles of dissolution. After the decree of

dissolution has been entered, the corporation pursuant to court order must wind up and liquidate in accordance with the provision of sections 14.06-14.08 (§§ 4-33-1406 — 4-33-1408).

### **Official Comment to Section 14.40 (1.C.A. 5 4-33-1440)\***

Section 14.40 (§ 4-33-1440) provides for the deposit of unclaimed assets with the state treasurer. State escheat or other laws provide for the ultimate disposition of these assets.

Section 14.40 (§ 4-33-1440) provides that assets deposited with the state treasurer shall be reduced to cash unless they are subject to known trust restrictions or

the treasurer decides it is in the public interest to hold the assets in kind. The treasurer may decide to hold the assets in kind when they are unique from an artistic or historical perspective.

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 15.01 (A.C.A. § 4-33-1501)**

"A state may prescribe the terms and conditions upon which a foreign corporation is permitted to transact business within the state, subject, of course, to the restrictions of the United States Constitution. Chapter 15 requires that a foreign corporation seeking to transact business within the state must (1) obtain a certificate of authority from the secretary of state and (2) maintain a registered office

and appoint a registered agent within the state....

"The Model Act does not attempt to formulate an inclusive definition of what constitutes the transaction of business. Rather, the concept is defined in a negative fashion by section 15.01(b), which states that certain activities do *not* constitute the transaction of business. In general terms, any conduct more regular, sys-

tematic, or extensive than that described in section 15.01(b) constitutes the transaction of business and requires the corporation to obtain a certificate of authority. Typical conduct requiring a certificate of authority includes maintaining an office to conduct local intrastate business, selling personal property not in interstate commerce, entering into contracts relating to the local business or sales, and owning or using real estate for general corporate purposes. But the passive owning of real estate for investment purposes does not constitute transacting business. See section 15.01(b)(9).

"The test of 'transacting business' defined in a negative way in section 15.01(b) applies only to the question of whether the corporation's contacts with the state are such that it must obtain a certificate of authority. It is not applicable to other questions such as whether the corporation is amenable to service of process under state "long-arm" statutes or liable for state or local taxes. A corporation that has obtained (or is required to obtain) a certificate of authority to transact business under chapter 15 will generally be subject to suit and state taxation in the state, while a corporation that is subject to service of process or state taxation in a state will not necessarily be required to obtain a certificate of authority under chapter 15.

"The list of activities set forth in section 15.01(b) is not exhaustive. See section 15.01(c). The list excludes several different types of activities from the definition of 'transacting business,' which are discussed below." Official Comment to Model Business Corporation Act Section 15.01 (§ 4-27-1501).

A corporation is not "transacting business" by "maintaining, defending or set-

ting any proceeding" in a State. Section 15.01(b)(1) (§ 4-33-1501(b)(1)). The term "proceeding" is broadly defined in Section 1.40(27) (§ 4-33-140(28)) to include civil suits and criminal, administrative and investigatory actions.

A corporation may carry on activities concerning its internal corporate affairs and hold directors' and members' meetings without transacting business within a state. Section 15.01(b) (§ 4-33-1501(b)). "Other activities relating to the internal affairs of the corporation that do not constitute the transaction of business under Section 15.01(b) include having Officers or representatives of a corporation who reside within or are physically present in the state ... make executive decisions relating to the affairs of the corporation without imposing on the corporation the requirement that it obtain a certificate of authority in the state, provided these activities are not so regular and system[ati]c as to cause the residence to be viewed as a business office." Official Comment to Model Business Corporation Act Section 15.01 (§ 4-27-1501).

"A corporation is not 'transacting business' ... if it is transacting business in interstate commerce ... or soliciting or obtaining orders that must be accepted outside the state before they become contacts.... These limitations reflect the provisions of the United States Constitution that grant to the United States Congress exclusive power over interstate commerce, and preclude states from imposing restrictions or conditions upon this commerce. These sections should be construed in a manner consistent with judicial decisions under the United States Constitution." Official Comment to Model Business Corporation Act Section 15.01 (§ 4-27-1501).

### **Official Comment to Section 15.02 (A.C.A. § 4-33-1502)\***

Section 15.02 (§ 4-33-1502) is designed to compel foreign corporations to qualify to transact business in a state by obtaining a certificate of authority but not to impose Draconian penalties on those who fail to qualify. The failure to qualify does not impair the validity of corporate acts or prevent a corporation from defending itself in any proceeding. Section 15.01(e) (§ 4-33-1501(e)).

A corporation that is required to qualify,

but has not qualified, may not bring suit or seek an affirmative recovery in an action in which it is a defendant until it has qualified. A court may stay a proceeding commenced by a foreign corporation until it determines whether the corporation should have qualified to transact business. If it concludes that qualification is necessary, it may grant a further stay until the foreign corporation obtains a certificate of authority. A foreign corpora-



tion that is required to but has not obtained a certificate of authority may do so and is not required to refile the suit.

Subsection (d) (§ 4-33-1502(d)) provides a specified dollar amount per day with a maximum yearly total penalty for each year in which a foreign corporation fails to qualify. Each state adopting the

Model Act (§ 4-33-101 et seq.) should determine the appropriate daily and yearly amounts and insert them in subsection (d) (§ 4-33-1502 (d)).

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 15.03 (A.C.A. § 4-33-1503)**

Section 15.03 (§ 4-33-1503) requires corporations to submit specified information to obtain a certificate of authority. "The purposes of these disclosure requirements are: (1) to ensure that citizens of the state have adequate information about foreign corporations in their transactions with them; (2) to put them in a status of equality with domestic corporations with respect to information required to be furnished; (3) to facilitate their subjection to the jurisdiction of the state's courts, thereby removing any disadvantage citizens of the state may have when dealing with them; and (4) to provide

readily accessible evidence of their existence." Official Comment to Model Business Corporation Act Section 15.03 (§ 4-27-1503). Each application for a certificate of authority must be accompanied by a certificate of existence (or document of similar import) and the filing fee set forth in section 1.22 (§ 4-33-122).

Section 16.22 (not enacted by Arkansas) requires qualifying corporations to file annual reports with the secretary of state. They may also have to make other filings pursuant to sections 15.04, 15.06, and 15.07 (§§ 4-33-1504, 4-33-1506, and 4-33-1507), and regulatory and tax statutes.

### **Official Comment to Section 15.04 (A.C.A. § 4-33-1504)**

A foreign corporation must file an amended certificate of authority if it changes its corporate name, the period of its duration or the state or country of its incorporation. A change in registered office or registered agent requires an imme-

diate filing pursuant to section 15.07 (§ 4-33-1507). Changes in principal office, officers or directors only have to be reported in the annual report filed yearly with the secretary of state pursuant to section 16.22 (not enacted by Arkansas).

### **Official Comment to Section 15.05 (A.C.A. § 4-33-1505)**

Foreign corporations that have a valid certificate of authority have the same but no greater rights, and the same but no greater privileges, as domestic corporations of a like character. Similarly qualified foreign corporations, except as otherwise provided in the Model Act (§ 4-33-101 et seq.), are subject to the same duties, restrictions, penalties and liabilities as domestic corporations of a like character. As the Model Act (§ 4-33-101 et seq.) draws distinctions between public benefit, mutual benefit and religious corporations, foreign corporations should determine in which category they would fall if they were domestic corporations. See sections 15.03(a) (8) and 17.07 (§§ 4-33-1503(a) (8) and 4-33-1707).

While the Model Act (§ 4-33-101 et seq.) does not authorize a state to regulate the "organization or internal affairs" of a foreign corporation, the exact meaning of "organization and internal affairs" is left to court determination. Section 15.05 (§ 4-33-1505), however, is not intended to preempt regulatory statutes that would otherwise be applicable to a foreign nonprofit corporation.

The common law in some states may give a state jurisdiction over assets held in trust by a foreign nonprofit corporation. The extent of this jurisdiction, if any, is not set forth in the Model Act (§ 4-33-101 et seq.).

**Official Comment to Section 15.06 (A.C.A. § 4-33-1506)**

Section 15.06 (§ 4-33-1506) requires qualified foreign corporations to have names distinguishable from other corporate names on the records of the secretary of state. Section 15.06 (§ 4-33-1506) requires the secretary of state to evaluate names based on the secretary of state's records. It does not require the secretary of state to decide issues relating to unfair competition. See section 4.01 (§ 4-33-401).

If the true corporate name of a foreign

corporation is unavailable, the foreign corporation may use a fictitious name to transact business if it delivers a certified copy of a board resolution adopting the fictitious name together with its application for a certificate of authority. The fictitious name must be one that is otherwise available. States adopting the Model Act (§ 4-33-101 et seq.) may have registration, filing or other requirements applicable to the use of fictitious names.

**Official Comment to Section 15.07 (A.C.A. § 4-33-1507)**

Section 15.07 (§ 4-33-1507) requires each foreign corporation authorized to transact business in a state to maintain continually a registered office and registered agent in the state so it will be amenable to suit within the state. Section

15.07 (§ 4-33-1507) is based on section 5.01 (§ 4-33-501). See Official Comment to Section 5.01 (§ 4-33-501) for an explanation of the policies upon which section 15.07 (§ 4-33-1507) is based.

**Official Comment to Section 15.08 (A.C.A. § 4-33-1508)**

Section 15.08(a) (§ 4-33-1508(a)) requires foreign corporations upon changing their registered office or registered agent to file a statement with the secretary of state containing the information required by section 15.08(a) (§ 4-33-1508(a)). If the office of the registered agent is changed, the agent may change the registered office by notifying the secretary of state and

complying with the provisions of section 15.08(b) (§ 4-33-1508(b)) rather than section 15.08(a) (§ 4-33-1508(a)). Section 15.08 (§ 4-33-1508) is based on section 5.03 (§ 4-33-503). See Official Comment to Section 5.03 (§ 4-33-503) for an explanation of the policies upon which section 15.08 (§ 4-33-1508) is based.

**Official Comment to Section 15.09 (A.C.A. § 4-33-1509)\***

Section 15.09 (§ 4-33-1509) permits a registered agent of a foreign corporation to resign upon fulfilling the requirements set forth in the section. See Official Comment to Section 5.03 (§ 4-33-503) for an explanation of the policies underlying section 15.09 (§ 4-33-1509).

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\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 15.10 (A.C.A. § 4-33-1510)\***

Section 15.10 (§ 4-33-1510) sets forth nonexclusive ways of serving foreign corporations. Section 15.10(a) (§ 4-33-1510(a)) allows service to be made upon a registered agent of a qualified foreign corporation. Section 15.10(b) (§ 4-33-1510(b)) authorizes service on the secretary of the foreign corporation in the

manner and at the places specified if the foreign corporation does not have a registered agent, the registered agent cannot be found at the registered office, the corporation has withdrawn from the state or the foreign corporation's certificate of authority has been revoked. Section 15.10 (§ 4-33-1510) is based on section 5.04



(§ 4-33-504). See Official Comment to Section 5.04 (§ 4-33-504) for an explanation of the policies underlying Section 15.10 (§ 4-33-1510).

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 15.20 (A.C.A. § 4-33-1520)**

A foreign corporation authorized to transact business in a state must file an application for a certificate of withdrawal to withdraw from the state. The application must appoint the secretary of state as agent for service of process in any proceeding based on a cause of action arising during the time the corporation was authorized to transact business in the state. If the secretary of state is served as agent for the foreign corporation, the secretary of state must mail a copy of the process to the foreign corporation at the address set forth in the application for withdrawal.

Subsection 15.20(b) (§ 4-33-1520(b)) sets forth the information that must be contained in the application for a certificate of withdrawal. The application for withdrawal must be on the form prescribed by the secretary of state. See section 1.21 (§ 4-33-121). This insures that the appointment of the secretary of state as agent for service of process is unqualified and not limited in a way inconsistent with the requirements of section 15.20 (§ 4-33-1520).

### **Official Comment to Section 15.30 (A.C.A. § 4-33-1530)\***

Section 15.30 (§ 4-33-1530) authorizes the secretary of state or attorney general to commence an administrative proceeding under section 15.31 (§ 4-33-1531) to revoke a foreign corporation's certificate of authority. This revocation may take place for the reasons specified in section 15.30 (§ 4-33-1530) pursuant to the procedures set forth in section 15.31 (§ 4-33-1531).

See Official Comment to Section 14.20 (§ 4-33-1420) for an explanation of the policies underlying section 15.30 (§ 4-33-1530).

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 15.31 (A.C.A. § 4-33-1531)\***

Section 15.31 (§ 4-33-1531) sets forth the method by which the certificate of authority may be revoked. The foreign corporation must be advised of the proposed revocation and have an adequate opportunity to take action to prevent the revocation from taking place. A foreign corporation that believes that it has been improperly treated may seek judicial review of the revocation pursuant to section 15.32 (§ 4-33-1532).

Section 15.31 (§ 4-33-1531) is based on section 14.21 (§ 4-33-1421). See Official Comment to Section 14.21 (§ 4-33-1421) for an explanation of the policies underlying section 15.31 (§ 4-33-1531).

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\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 15.32 (A.C.A. § 4-33-1532)**

Section 15.32 (§ 4-33-1532) authorizes a foreign corporation to appeal from the secretary of state's revocation of its certificate of authority. States adopting this section (§ 4-33-1532) should indicate the court in which the appeal should be filed.

Normally this should be a court in the county of the corporation's principal office or a court in the state capitol. States adopting this section (§ 4-33-1532) should also specify the party who has the burden of proof and the standard for judicial re-

view. See Official Comment to Section 1.26 (§ 4-33-126).

### Official Comment to Section 16.01\*

Section 16.01 requires corporations to keep specified records. The remainder of the chapter deals with members' rights to inspect, copy and receive copies of these records and reports.

#### **1. Permanent Records**

Section 16.01(a) requires a corporation to keep permanent records of: (i) minutes of all meetings of its members and a record of all actions taken by its members by written ballot and written consent without a meeting (see sections 7.04 and 7.06 (§§ 4-33-704 and 4-33-708); and (ii) minutes of all meetings of its directors, all actions taken by directors without a meeting, and all actions taken by committees of the board in place of the board (see section 8.25 (§ 4-33-825)).

A corporation is required to keep permanent records of board committee actions only when: (i) the committee takes action in place of the board, and (ii) the committee is appointed pursuant to section 8.25 (§ 4-33-825). If the committee is appointed pursuant to section 8.25 (§ 4-33-825) but does not take action in place of the board, section 16.01(a) does not require a record of its activities. If the action taken is only advisory, section 16.01(a) does not require a record of the deliberations or advice.

Section 16.01(a) does not require a corporation to keep permanent records of non-board committee actions.

The underlying rationale of section 16.01(a) (§ 4-33-1601(a)) is that there should be a permanent record of actions taken by the members, the board and committees of the board acting in place of the board. The section does not require that the minutes or record of an action include a discussion of or reasons for an action. The amount of detail is left to the discretion of each nonprofit organization. The minutes or records may merely recite that after consideration a certain action was taken or they may go into great detail as to the background, rationale and reasons for the particular action.

#### **2. Accounting Records**

Section 16.01(b) requires a corporation to maintain "appropriate accounting

records." The required records are the current accounting records of the corporation. Section 16.01(b) does not require that these records be kept permanently or address the question of how long accounting records should be kept. For tax, regulatory and record-keeping reasons each nonprofit corporation should determine how long it should keep its accounting records.

The question of what accounting records are "appropriate" depends on the nature, size and other characteristics of the corporation. Numerous nonprofit corporations have a relatively small amount of money and operate with volunteer staffs. In such cases, "appropriate accounting records" may be composed of checkbooks, cancelled checks and receipts. In the case of entities with significant funds, more detailed accounting records are appropriate.

"Appropriate" records should allow the financial statements to be prepared in a fashion that fairly presents the financial condition and results of operations of the corporation. There is no requirement that accounting records be kept in accordance with generally accepted accounting principles. Many nonprofit corporations operate on a cash rather than an accrual basis. As accounting for nonprofit organizations is presently in a state of transition, no particular approach is required by the Model Act (§ 4-33-101 et seq.).

#### **3. Membership Lists**

Section 16.01(c) requires a corporation to maintain a record of its current members in a form that allows preparation of an alphabetical list of members, their addresses, by class, and an indication of the number of votes each member is entitled to cast. The records themselves do not have to be kept in this form. Sections 16.02 through 16.05 deal with the circumstances under which membership lists are available for inspection and copying.

#### **4. Form of Records**

Section 16.01(d) requires that corporate records be maintained in written form or another form capable of conversion into a written form within a reasonable time.



This allows nonprofit organizations to keep records on microfilm or microfiche, in computer memory or in any other appropriate manner. The records must, however, be kept in a form that allows the corporation to comply with members' rights to obtain and inspect the records.

### **5. Records Required at Principal Office**

Section 16.01(e) requires that specified corporate records be kept at the principal office of the corporation. For domestic corporations the principal office of the corporation is defined in section 1.40(26) (§ 4-

33-140(27)) as an office in the state designated in the annual report filed pursuant to section 16.22. Section 16.22 requires a corporation to designate annually the address of its principal office in the state. In some instances, particularly for small nonprofit corporations, the home of an officer or director may be the principal office of the corporation.

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\*This section was not enacted by Arkansas.

## **Official Comment to Section 16.02\***

### **1. Automatic Access to Certain Records**

Section 16.02(a) gives each member the right to inspect and copy at a reasonable time and place the records described in section 16.01(e). This right is conditioned only upon the member giving the corporation written notice of the demand at least five business days before the date on which the member wishes to inspect and copy the records and paying any reasonable charge the corporation may impose pursuant to section 16.03(c). The member does not have to show that the demand is made in good faith for a proper purpose. Nor does the member have to show the purpose for the request or that the records are directly connected with the member's purpose.

### **2. Limited Access to Certain Records**

Section 16.01(b) allows members to copy and inspect specified records, but imposes more conditions than section 16.01(a). Members have the right to inspect the following types of records:

(1) Excerpts of any meetings of the board, records of any action of a committee of the board as authorized by section 8.25 (§ 4-33-825) while acting in place of the board, minutes of any meeting of members and records of actions taken by members or directors without a meeting to the extent not subject to inspection under section 16.02(a).

(2) The accounting records of the corporation. See Official Comment to Section 16.01 for a discussion of what accounting records the corporation must keep.

(3) The membership list. See section

16.05 for limitations on use of the membership list. Also see section 7.20 (§ 4-33-720) for the right members have to inspect membership lists beginning two business days after notice of the membership meeting is given and continuing through the meeting.

A demand to copy and inspect records under section 16.01 (b) must be made in good faith for a proper purpose. See section 16.01(c). The proper purpose must reasonably relate to the member's interest as a member, which may be broader than a shareholder's interest in a business corporation. In addition, the member must describe with reasonable particularity the purpose and the records the member desires to inspect. The object of this requirement is to inform the corporation in general terms of the object of the member, not to limit the purpose of the inspection rights. Thus, for example, a request to contact fellow members concerning the corporation or a request to examine records to determine whether improper transactions have occurred or a charitable trust breached states a proper purpose.

### **3. Religious Corporations**

The articles or bylaws of religious corporations may limit or abolish the rights of inspection set forth in section 16.02. If no limit is placed on these rights, members of religious corporations have the same inspection rights under section 16.02 as members of other nonprofit corporations. Even if the articles or bylaws limit the rights set forth in section 16.02, a member may still have other inspection rights. See section 16.02(d).

#### **4. Additional Rights of Inspection**

The rights set forth in section 16.02 may not be abolished or limited by a public benefit or mutual benefit corporation. Moreover the rights set forth in section 16.02 are not exclusive. Section 16.02(d) "provides that the right of inspection granted by section 16.02 is an independent right of inspection that is not a substitute for or in derogation of rights of inspection that may exist (1) under section 7.20, to inspect the [membership] list following the establishment of a record date for a meeting; (2) as part of a right of discovery that exists in connection with

litigation; and (3) as a 'common law' right of inspection, if any is found to exist by a court, to examine corporate records. Section [16.02(d)] simply preserves whatever independent right of inspection exists under these sources and does not create or recognize any rights, either expressly or by implication." Official Comment to Model Business Corporation Act Section 16.02 (§ 4-27-1602).

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\*This section was not enacted by Arkansas.

#### **Official Comment to Section 16.03\***

Section 16.03 allows a member's agent and attorney to have the same inspection and copying rights as the member. These rights include the right, if reasonable, to receive copies made by photographic, xerographic or other means. In some instances corporations may keep records in bubble memories, computer disks or other nonprinted form. If reasonable, section

16.03 requires corporations to make copies of these records and charge the member for the cost of reproduction. The cost of reproduction includes the cost of preparing the information for reproduction and reproducing the information.

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\*This section was not enacted by Arkansas.

#### **Official Comment to Section 16.04\***

##### **1. Summary Procedure for Refusal to Comply with Section 16.02(a)**

Members have the right under section 16.02(a) to inspect the records described in section 16.01(e) simply by showing that they are members of the corporation. If the corporation refuses to allow inspection of the records, the member or members may seek a summary order directing the corporation to allow inspection and copying at the corporation's expense. See section 16.02(e) for a list of the records that are subject to this summary procedure.

##### **2. Expedited Procedure for Refusal to Comply with Section 16.02(b)**

Members have the right to inspect and copy certain records under section 16.02(b) and, depending on state law, the common law. Members seeking to enforce these rights are entitled to a hearing on "an expedited basis." However, a member must comply with the requirements of subsections 16.02(b) and (c) and, if applicable, section 16.05 prior to obtaining access to the records. Consequently the court procedure may take longer than the procedure to obtain records under section 16.02(a).

The Model Act (§ 4-33-101 et seq.) does not indicate who should pay for inspection and copying of records if it is necessary to obtain a court order to enforce section 16.02(b) or common law rights. This matter is left to the discretion of the court.

##### **3. Payment of Costs Including Reasonable Counsel Fees**

If a court orders inspection and copying of records the corporation must pay the member's costs "including reasonable counsel fees" incurred in obtaining the order unless the corporation proves that its refusal is in good faith because it had a reasonable basis for doubt about the member's right to inspect the records. "This normally will involve reasonable doubt whether the [member] had the necessary good faith and proper purpose or whether the records demanded are directly connected to the [member's] purpose. The phrase 'in good faith because it had a reasonable basis for doubt' establishes a partially objective standard, in that the corporation must be able to point to some objective basis for its doubt that the [member] was acting in good faith or had



a purpose that was proper. For example, a corporation may point to earlier conduct of the [member] involving improper use of information obtained from the corporation in the past as indicating that reasonable doubt existed as to his present purpose. A corporation may not avoid the imposition of costs under this section merely by showing it had no information one way or the other about the issues in controversy.”

Official Comment to Model Business Corporation Act Section 16.04 (§ 4-27-1604). See section 16.05 for limitations on the uses to which membership lists can be put.

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\*This section was not enacted by Arkansas.

### Official Comment to Section 16.05\*

A nonprofit corporation's membership list is a valuable asset. For public benefit and religious corporations, the membership list may represent a list of contributors. For mutual benefit corporations the list may represent a list of members of a trade association, social club, political organization or other significant group. Section 16.05 sets forth the basic premise that a membership list may not be obtained or used by any person for any purpose unrelated to a member's interest as a member. It then provides that a membership list may not be used in any of the following three purposes without the board's consent:

(1) The solicitation of money or property unless such money or property will be used solely to solicit the votes of members in an election held by the corporation. A membership list therefore cannot be used by members who in good faith believe the organization has strayed from its purposes and want to solicit the members to contribute to a competitive organization that is carrying out the true purposes of the corporation whose membership list is sought. Nor can members use a membership list to solicit contributions for a non-competitive organization, even if the non-competitive organization has laudable purposes.

(2) Used for any commercial purpose. Commercial organizations frequently de-

sire to use membership lists of nonprofit organizations to contact members. Such use is only allowed if approved by the board of directors of the nonprofit corporation.

(3) Sold to or purchased by any person. Members of a nonprofit organization do not have the right to sell a membership list to any person. Nor may a person seeking a membership list purchase it except from the corporation with the approval of the board of directors.

A corporation must have some factual basis for believing that the members seeking the membership list will violate the provisions of section 16.05 to deny inspection rights pursuant to section 16.05. If a corporation has a legitimate doubt as to the purposes for which a member seeks a membership list, the matter can be heard by a court pursuant to section 16.04. The court should closely scrutinize the transaction to determine whether a member has a legitimate purpose or whether the corporation was simply using section 16.05 as a ruse to prevent and frustrate a member's rights. See Official Comment to Section 16.04 for the circumstances in which a court may order the corporation to pay attorney fees and costs.

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\*This section was not enacted by Arkansas.

### Official Comment to Section 16.20\*

Nonprofit organizations are not required to mail annual financial statements to any member unless the member makes a written demand for the latest financial statements. The cost of an automatic mailing to all members would be prohibitive for some nonprofit organiza-

tions. In many instances, the only financial report that members receive is an oral report at an annual meeting. While the bylaws of some organizations require that annual financial statements be delivered to all members, section 16.20 only requires that the latest annual financial

statement be furnished to a member upon written demand of that member. In addition, members have the right to receive a report on the financial condition of the corporation at the annual meeting. Section 7.01(c) (§ 4-33-701(c)).

Because there is so much diversity in nonprofit organizations and because accounting treatment of nonprofit corporations is in a transition state, section 16.20 does not require that financial statements be prepared on the basis of generally accepted accounting principles. However, if the corporation prepares financial statements on the basis of generally accepted accounting principles, the annual financial statements must also be prepared on that basis.

There is no requirement that the annual financial statements be audited. Where, however, they are audited, the accountant's report must accompany the statement.

"Section 16.20 refers to a 'public accountant.' The same terminology is used in section 8.30 (standards of conduct for directors) of the Model Act. In various states, different terms are employed to identify those persons who are permitted under the state licensing requirements to act as professional accountants. Phrases like 'independent public accountant,' 'certified public accountant,' 'public accountant,' and others may be used. In adopting the term 'public accountant,' the Model Act uses the words in a general sense to refer to any class or classes of persons who, under the applicable requirements of a particular jurisdiction, are professionally entitled to practice accountancy." Official Comment to Model Business Corporation Act Section 16.20 (§ 4-27-1620).

If the financial statements are not reported upon by an accountant, they must be accompanied by a report of the president or other person in charge of the corporation's financial accounting records.

The object of the report is to describe the basis upon which the financial statements were prepared so the members will have a basis for evaluating them. The report must:

(1) indicate the reporting person's reasonable belief as to whether the statements were prepared on the basis of generally accepted accounting principles. If not, the report should describe the basis on which the statements were prepared. The financial statements may, for example, be prepared on a cash basis. If so, the report should so indicate.

In some circumstances, the financial records of the organization may be in a state of disarray. If so, this fact should be disclosed. The report should indicate how the statements were prepared. If appropriate, the report may have to state that the financial statements do not fairly reflect the condition and operations of the corporation.

(2) describe any respects in which the financial statements were not prepared on a basis consistent with the statements prepared for the preceding year. Members are entitled to know whether the financial statements were prepared on a consistent basis so they can determine whether a year-to-year comparison of financial reports will yield comparable figures.

Business and nonprofit corporations control subsidiaries through stock ownership. Nonprofit corporations control other nonprofit corporations by holding all or a majority of their memberships or through article or bylaw provisions. The term "affiliates" in section 16.20 refers to corporations controlled by nonprofit corporations regardless of whether control is exercised through memberships, or articles or bylaw provisions.

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\*This section was not enacted by Arkansas.

### Official Comment to Section 16.21\*

Section 16.21 requires that members be notified of indemnification of directors under sections 8.51, 8.52 and 8.54 (§§ 4-33-851, 4-33-852 and 4-33-854) and advances for expenses under section 8.53 (§ 4-33-853). The report must be made only if the payment or advances were made in a

derivative action. The report must be made with or before the notice of the next members' meeting.

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\*This section was not enacted by Arkansas.



**Official Comment to Section 16.22\***

Domestic and foreign corporations qualified to transact business in a state must file an annual report at the times indicated in section 16.22(c). The report must contain the information required by section 16.22(a).

The annual report is a public document open to inspection by members, the general public, the attorney general and other state officials. It is a convenient way to locate a corporation and its directors and principal officers. The exact form will be prescribed by the secretary of state pursuant to section 1.21 (§ 4-33-121). In the normal instance it will call for the name, and business or residence address of those corporate officers who serve as presiding officer of the board, president, or chief executive officer, secretary, and treasurer.

Nonprofit corporations may provide different names or titles for officers carrying out these functions. However, information concerning the officer carrying out the designated function should be set forth in the annual report.

If a domestic corporation fails to file the annual report, it is subject to administrative dissolution. See section 14.20 (§ 4-33-1420). If a foreign corporation qualified to transact business in a state fails to file an annual report, it is subject to revocation of its certificate of authority. See section 15.30 (§ 4-33-1530).

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\*This section was not enacted by Arkansas.

**Official Comment to Section 17.01 (A.C.A. § 4-33-1701)\***

The underlying concept of the Model Act (§ 4-33-101 et seq.) is that it applies to all or substantially all nonprofit corporations organized in a state. Many states have a general nonprofit corporation statute and special laws for particular types or categories of nonprofit corporations. The Model Act (§ 4-33-101 et seq.) provides an opportunity to adopt a unified, consistent and understandable law applicable to all or substantially all nonprofit organizations in a state. States adopting the Model Act (§ 4-33-101 et seq.) should specify the statutes it replaces.

The concept of a uniform law is enhanced by the mandate of section 17.01 (§ 4-33-1701) that the Model Act (§ 4-33-101 et seq.) is applicable on its effective date to all corporations subject to its provisions. See section 17.06 (§ 4-33-1706) for provisions relating to the effective date.

Section 17.01 (§ 4-33-1701) applies to corporations formed under statutes that have reserved the right to amend or repeal their provisions. The Model Act (§ 4-

33-101 et seq.) may therefore be made applicable to all corporations to which it can be constitutionally applied. As most statutes adopted in this century have a "reservation of power" clause the Act (§ 4-33-101 et seq.) will have general applicability to most nonprofit corporations.

Some states may wish to adopt optional subsection (b) (not enacted by Arkansas) which allows a few nonprofit corporations to decide whether or not to be governed by the provisions of the Model Act (§ 4-33-101 et seq.). Usually these corporations would be corporations formed under old statutes or charters that did not reserve the power of amendment, or religious corporations formed under some special statute. These corporations might prefer the Model Act (§ 4-33-101 et seq.) and should be given the opportunity to come under its provisions in whole or in part.

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\*The version of this section enacted by Arkansas differs from the Model Act.

**Official Comment to Section 17.02 (A.C.A. § 4-33-1702)\***

Foreign corporations are subject to the Model Act (§ 4-33-101 et seq.) as of its

effective date. See section 17.06 (§ 4-33-1706). However as a result of section 17.02

(§ 4-33-1702), it is not necessary for foreign corporations to obtain a new certificate of authority to transact business.

\*The version of this section enacted by Arkansas differs from the Model Act.

### **Official Comment to Section 17.03 (A.C.A. § 4-33-1703)**

Section 17.03 (§ 4-33-1703) is derived from section 25 of the Uniform Statutory Construction Act adopted by the National

Conference of Commissioners on Uniform State Laws in 1965.

### **Official Comment to Section 17.04 (A.C.A. § 4-33-1704)**

Section 17.04 (§ 4-33-1704) is a standard severability provision.

### **Official Comment to Section 17.05 (A.C.A. § 4-33-1705)**

The Model Act (§ 4-33-101 et seq.) is a statute of general applicability. Therefore, existing statutes should be repealed upon enactment of the Model Act (§ 4-33-101 et seq.).

Numerous states have statutes applying to special categories of nonprofit corporations. These statutes should be examined to determine whether there is any rationale for their continued existence. In general, multiple statutes lead to confusion and uncertainty. In some instances, the officers of nonprofit corporations may not be aware of these special statutes and may incorrectly assume that their non-

profit corporations are subject to the general nonprofit law of the state.

In some instances, it is necessary to continue statutes for specific types of nonprofit corporations. These statutes may incorporate particular provisions of the general nonprofit law or apply the nonprofit law "except as otherwise provided" or "except as inconsistent with" the general law. If these laws are not repealed, the references should be amended to refer to the revised Model Act (§ 4-33-101 et seq.) and not to the statute or statutes it replaces.

### **Official Comment to Section 17.06 (A.C.A. § 4-33-1706)**

Section 17.06 (§ 4-33-1706) provides a uniform effective date for the Model Act (§ 4-33-101 et seq.). Section 17.06 (§ 4-33-1706) should be read in connection with the provisions contained in section 17.03 (§ 4-33-1703). As a result of section 17.03 (§ 4-33-1703) certain actions commenced prior to the effective date of the Act (§ 4-33-101 et seq.) are valid if they conform to the prior law.

The effective date of the Model Act (§ 4-33-101 et seq.) should be at least a year after its adoption. This will allow time for nonprofit corporations to become aware of the new law and make any changes that may be necessary or desirable to comply with its provisions.

The following optional provision may be added to section 17.06\* (§ 4-33-1706):

except that the provisions of sections 8.50-8.58 shall be applicable to acts or omissions occurring prior to \_\_\_\_\_ [fill in effective date of Act].

If the optional provision of section 17.06 (§ 4-33-1706) relating to indemnification is adopted, the indemnification provisions of the Model Act (§ 4-33-101 et seq.) will apply to acts or omissions occurring prior to its effective date. Many states do not have comprehensive indemnification provisions for officers and directors. The effect of adopting the optional provision of section 17.06 (§ 4-33-1706) is to allow a corporation to indemnify its officers and directors after the effective date of the Model Act (§ 4-33-101 et seq.) based on the provisions contained in sections 8.50 through 8.58 (§§ 4-33-850 — 4-33-858)



even though the indemnified act or omission occurred prior to the effective date. [A very few states may have indemnification provisions that are broader than those contained in the Model Act (§ 4-33-101 et seq.). These states should seriously con-

sider the effect of adopting the optional provision.]

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\*Arkansas did not enact the optional provision.

### **Official Comment to Section 17.07 (A.C.A. § 4-33-1707)\***

Section 17.07 (§ 4-33-1707) sets forth the rules for determining whether nonprofit corporations existing on the effective date of the Model Act (§ 4-33-101 et seq.) are public benefit, mutual benefit or religious corporations.

Subsection (1) (§ 4-33-1707 (1)) provides that corporations may be designated by a statute other than the Model Act (§ 4-33-101 et seq.) as public benefit, mutual benefit or religious corporations. Health maintenance organizations or other corporations may feel that the type of corporation they would be required to be under subsections (2)-(5) (§ 4-33-1707(2) — (5)) is inappropriate. If so, they can be designated as a public benefit, mutual benefit or religious corporation under a law other than the Model Act (§ 4-33-101 et seq.).

A corporation not covered by subsection (1) (§ 4-33-1707(1)) that is organized primarily or exclusively for religious purposes is a religious corporation.

Under section (3) (§ 4-33-1707(3)) a corporation not falling within subsections (1) or (2) (§ 4-33-1707(1) or (2)) that is recognized as exempt under section 501(c)(3) of the Internal Revenue Code, or any successor section, is a public benefit corporation. A corporation obtains the tax benefits of section 501(c)(3) by holding itself out as operating for a public or charitable purpose and not for the private benefit of its officers, directors, members or controlling persons. Its entire reason for being is to operate in the public interest. Consequently the Model Act (§ 4-33-101 et seq.) requires it to be a public benefit corporation. See Introduction to Model Nonprofit Corporation Act (§ 4-33-101 et seq.) for a discussion of public benefit corporations.

Subsection (4) (§ 4-33-1707(4)) provides that any corporation not falling under subsection (1), (2), or (3) (§ 4-33-1707(1), (2), or (3)) is a public benefit corporation if: (i) it is organized for a public or charitable purpose; and (ii) upon dissolution its as-

sets must be distributed to the United States, a public benefit corporation, a state or a section 501(c)(3) organization. Because corporations described by subsection (4) (§ 4-33-1707(4)) have the same objectives as public benefit corporations and their members have no economic interest in their assets, they are in effect and the Model Act (§ 4-33-101 et seq.) treats them as public benefit corporations. The Sierra Club or some other organizations holding themselves out as operating for a public purpose, but that have lost or never obtained section 501(c)(3) tax status because of political activities would fall within the provision of subsection (4) (§ 4-33-1707(4)) if their assets must be distributed to a public benefit corporation, the United States, a state or a section 501(c)(3) organization.

A corporation that exists on the effective date of the Model Act (§ 4-33-101 et seq.) may consider itself to be a public benefit corporation, but not have the dissolution clause described in subsection (4) (§ 4-33-1707(4)). If it wishes to become a public benefit corporation, it should amend its articles to insert an appropriate dissolution clause.

Subsection (5) (§ 4-33-1707(5)) is a catch-all provision. Any corporation not otherwise covered by subsections (1) through (4) (§ 4-33-1707(1) — (4)) is treated as a mutual benefit corporation by subsection (5) (§ 4-33-1707(5)). The members of many of these corporations have an economic interest in the corporate assets upon dissolution. Country clubs and social organizations typically fall within this category. Some corporations may be formed for the private benefit of their members, but must distribute their assets on dissolution to a section 501(c)(3) organization. They would be treated as mutual benefit corporations by subsection (5) (§ 4-33-1707(5)).

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\*The version of this section enacted by Arkansas differs from the Model Act.

## UNIFORM PARTNERSHIP ACT (§ 4-42-101 ET SEQ.)

### Commissioners' Prefatory Note

The subject of a uniform law on partnership was taken up by the Conference of Commissioners on Uniform State Laws in 1902, and the Committee on Commercial Law was instructed to employ an expert and prepare a draft to be submitted to the next annual Conference. (See Am. Bar Assn. Report for 1902, p. 477.) At the meeting in 1903 the committee reported that it had secured the services of James Barr Ames, Dean of the Law School of Harvard University, as expert to draft the act. (See Am. Bar Assn. Report for 1903, p. 501.)

In 1905 the Committee on Commercial Law reported progress on this subject, and a resolution was passed by the Conference, directing that a draft be prepared upon the mercantile theory. (See Am. Bar Assn. Reports, 1905, pp. 731-738.) And in 1909 the committee reported that it had in its hands a draft of an act on this subject, which draft was recommitted to the committee for revision and amendment, with directions to report to the next Conference for discussion and action. (See Report, C. U. S. L., 1906, p. 40.)

In 1907 the matter was brought before the Conference and postponed until the 1908 meeting. (See Report, C. U. S. L., 1907, p. 93.) In 1908 the matter was discussed by the Conference. (See Am. Bar Assn. Reports, 1908, pp. 983, 1048.) And in 1909 the Second Tentative Draft of the Partnership Act was introduced and discussed. (See p. 1081 of Am. Bar Assn. Reports for 1909.)

In 1910 the committee reported that on account of the death of Dean Ames no progress had been made, but that Dr. Wm. Draper Lewis, then Dean and now Professor of Law at the Law School of the University of Pennsylvania, and Mr. James B. Lichtenberger, of the Philadelphia Bar, had prepared a draft of a partnership act on the so-called entity idea, with the aid of the various drafts and notes of Dean Ames, and that they had also submitted a draft of a proposed uniform act, embodying the theory that a

partnership is an aggregate of individuals associated in business, which is that at present accepted in nearly all the states of the Union. (See Report, C. U. S. L., 1910, p. 142.) Dean Lewis expressed his belief that with certain modifications the aggregate or common law theory should be adopted. A resolution was passed by the Conference that any action that might have theretofore been adopted by it, tending to limit the Committee on Commercial Law in its consideration of the partnership law to what is known as the entity theory, be rescinded and that the committee be allowed and directed to consider the subject of partnership at large as though no such resolution had been adopted by the Conference. (See p. 52.)

In the fall of 1910 the committee invited to a Conference, held in Philadelphia, all the teachers of, and writers on, partnerships, besides several other lawyers known to have made a special study of the subject. There was a large attendance. For two days the members of the committee and their guests discussed the theory on which the proposed act should be drawn. At the conclusion of the discussion the experts present recommended that the act be drawn on the aggregate or common law theory, with the modification that the partners be treated as owners of partnership property holding by a special tenancy which should be called tenancy in partnership. (See section 25 of the act recommended.) Accordingly, at the meeting of the Conference in the summer of 1911, the committee reported that, after hearing the discussion of experts, it had voted that Dean Lewis be requested to prepare a draft of a partnership act on the so-called common law theory. (See Report, C. U. S. L., 1911, p. 149.)

The committee reported another draft of the act to the Conference at its session in 1912, drawn on the aggregate or common law theory, with the modification referred to. At this session the Conference spent several days in the discussion of the act, again referring it to the Committee on



Commercial Law for their further consideration. (See Report, C. U. S. L., 1912, p. 67.)

The Committee on Commercial Law held a meeting in New York on March 29, 1913, and took up the draft of the act referred back to it by the Conference, and after careful consideration of the amendments suggested by the Conference, prepared their seventh draft, which was, at their annual session in the summer of 1913, submitted to the Conference. The Conference again spent several days in discussing the act and again referred it to the Committee on Commercial Law, this time mainly for protection in form.

The Committee on Commercial Law assembled in the City of New York, September 21, 1914, and had before them a new draft of the act, which had been carefully prepared by Dr. Wm. Draper Lewis with valuable suggestions submitted by Charles E. Shepard, Esq., one of the commissioners from the State of Washington, and others interested in the subject. The committee reported the Eighth Draft to the Conference which, on October 14, 1914, passed a resolution recommending the act for adoption to the legislatures of all the states.

Uniformity of the law of partnerships is constantly becoming more important, as the number of firms increases which not only carry on business in more than one state, but have among the members residents of different states.

It is however, proper here to emphasize the fact that there are other reasons, in addition to the advantages which will result from uniformity, for the adoption of the act now issued by the Commissioners. There is probably no other subject connected with our business law in which a

greater number of instances can be found where, in matters of almost daily occurrence, the law is uncertain. This uncertainty is due, not only to conflict between the decisions of different states, but more to the general lack of consistency in legal theory. In several of the sections, but especially in those which relate to the rights of the partner and his separate creditors in partnership property, and to the rights of firm creditors where the personnel of the partnership has been changed without liquidation of partnership affairs, there exists an almost hopeless confusion of theory and practice, making the actual administration of the law difficult and often inequitable.

Another difficulty of the present partnership law is the scarcity of authority on matters of considerable importance in the daily conduct and in the winding up of partnership affairs. In any one state it is often impossible to find an authority on a matter of comparatively frequent occurrence, while not infrequently an exhaustive research of the reports of the decisions of all the states and the federal courts fails to reveal a single authority throwing light on the question. The existence of a statute stating in detail the rights of the partners inter se during the carrying on of the partnership business, and on the winding up of partnership affairs, will be a real practical advantage of moment to the business world.

The notes which are printed in connection with this edition of the act were prepared by Dr. Wm. Draper Lewis, the draftsman. They are designed to point out the few changes in the law which the adoption of the act will effect, and many of the confusions and uncertainties which it will end.

#### Official Comment to Section 2 (A.C.A. § 4-42-102)

The words "unless the contrary intention appears," found in many different sections, are omitted from [opening paragraph of] this section because throughout

this act the words defined in this section are not used in any other than the sense in which they are here defined.

**Official Comment to Section 3 (A.C.A. § 4-42-103)**

The word "notice" in judicial opinions and in other legal writings is often used when "knowledge" as here defined is intended. This has led to a great deal of confusion, of which the extraordinary expression "constructive notice" is evidence. To avoid this confusion the word "notice" as here defined designates definite things only, which, if proved to have been done, enable the person doing them to assert that notice has been had and claim the benefit thereof, irrespective of whether the person charged has had knowledge or not. By adhering strictly to this conception throughout the act, the things which a person must do in order to be confident that he can claim the benefit of "notice" are made plain.

A definition of the word "knowledge" enables it to be indicated clearly when "knowledge" as distinguished from "notice" must be had.

The present law in regard to that which must be done by the person who desired to be in a position to claim the benefit of "notice" is in considerable confusion. Under our case law, as a rule, in ordinary transactions, except those which relate to commercial paper, no one has had "notice" until he has "knowledge"; though, of course, "notice" to an agent is notice to a principal. Whether the delivery of a letter containing a "statement of a fact" would or would not be sufficient if the addressee did not read the letter is doubtful. The court might well hold that the addressee, by his neglect to read the statement, was estopped from denying that he had "notice." The change in the law, if it is a change, which the present section as now drawn effects, is, it is submitted, in the right direction. The section does not go to the extent of saying that the mere deposit of a "written statement of the fact" in the mail is enough to charge the addressee with "notice." The addressor by selecting the post-office, telegraph or other public service corporation, as the method by which the letter shall be transferred, makes them his agents, not the agents of the addressee. On the other hand the section

does go to the extent of declaring that if such written statement is received at the residence or place of business of the addressee in the usual way, the addressor, having done all that was reasonably possible to do to give the addressee "knowledge," should have the benefit of his diligence.

The section as drawn, in dealing with the character of the "statement of fact," where the statement is not a verbal statement merely requires a "written statement." The omission of the word "printed" is after deliberation. To insert the word "printed" might raise a doubt as to the effect of the delivery of a newspaper containing a "statement of the fact." There ought to be no doubt that this is an insufficient statement. Unquestionably, such delivery is not a delivery of a "written statement of fact," but, on the other hand, if a printed or typewritten statement of the fact — as the dissolution of the partnership — is made on a separate card which is enclosed in an envelope and given to the addressee, there would appear to be no doubt that any court would hold that "a written statement of the fact" had been delivered to such person. The principle is clear. Nothing should be regarded as "a written statement of the fact" which is not so prepared as to cause the one to whom it is addressed, as a reasonably prudent man, to read it. An exact definition of the character of the statement which is to be made is practically impossible; neither do we believe it to be desirable. The words employed, "written statement of the fact," do not preclude the statement from being typewritten or printed but they do emphasize — that which it is necessary to emphasize — that the statement must be a separate statement of the fact made to the addressee, and not a general statement for all the world to read or not as fancy dictates.

The notes to section 4 (A.C.A. § 4-42-104), *infra*, in regard to "estoppel" and "agency," will perhaps answer some questions which may arise in connection with the present section.



**Official Comment to Section 4 (A.C.A. § 4-42-104)**

Subdivision (1) (A.C.A. § 4-42-104(1)). This provision is customary in American Codes [Cal.C.C., section 4; 1 Ala. Code (1907), section 12; 1 Idaho Rev.Codes, section 4].

Subdivision (2) (A.C.A. § 4-42-104(2)). This paragraph, applying to the whole act, obviates the necessity of constant repetition of the principle. Its necessity is illustrated in the provisions relating to "notice," section 3(2) (A.C.A. § 4-42-103(2)), *supra*. A "written statement" may be delivered in such a way as to induce the person to whom it is delivered to abstain from reading it. No one who has thus delivered a written statement should be permitted to claim the benefit of the notice. This result might be attained by inserting after the word "deliverers," section 3(2)(b) (A.C.A. § 4-42-103(2)(b)), *supra*, the words "in good faith;" but these words would not provide for the case where the person who has delivered a written notice in good faith, changes his mind, and in bad faith reacquires the writing before it is read.

Subdivision (3) (A.C.A. § 4-42-104(3)). This act is a partnership act and not an act relating to agency or any branch thereof. One of the causes of the present confused use of the word notice is due to the attempt to mix two distinct things: what is notice to a person of a fact, and

how far notice to an agent is notice to a principal. The second question is wholly a question of the law of agency; the first has nothing to do with the law of agency. The first is dealt with in section 3 (A.C.A. § 4-42-103), *supra*; the second is not a question within the scope of a partnership act.

This paragraph also avoids constant reference throughout the act to agents. For instance, in section 9 (A.C.A. § 4-42-301), *infra*, there is provision that a partner cannot bind the partnership where the person dealing with him has knowledge that the partner with whom he deals has no authority to bind the partnership. The knowledge of an authorized agent of such person should, of course, be effectual. This paragraph in regard to the law of agency avoids any possibility of a different construction, and renders unnecessary the insertion of the words "or authorized agent" after the word "person" in the section referred to and other similar sections.

Subdivision (5) (A.C.A. § 4-42-104(5)). The wording is based on the American Codes. [Idaho Rev.Codes, section 4; Cal.C.C., section 4; Rev. Stat. of Colo. (1908), sections 467, 468; Gen. Stat. of Kan. (1905), 1633; 1 Burns Anno.Ind.Stat. (1908), sections 240, 241, 1356, 1359; Cobbeys Rev. Stat. Neb. 11, 363; 2 S. Dak. Comp. Laws (1908), 313, 316, 318.]

**Official Comment to Section 6 (A.C.A. § 4-42-201)**

Subdivision (1) (A.C.A. § 4-42-201(1)). Explanation of the Reason for the Words Employed in the Definition. The first inquiry is, Why say a partnership is "an association of two or more persons"? In view of the fact that the word "association" implies the acting together of two or more persons, why not merely say that a partnership is an association to carry on business in which the members are co-owners of the business? The word person includes, as stated in section 2 (A.C.A. § 4-42-102), *supra*, "individuals, partnerships, corporations, and other associations." The definition as worded thus asserts, what would be doubtful if the words "of two or more persons" were omitted, namely, that any one of these associations may become members of a partnership. It is true that if two or more

corporations attempt to form a partnership the contract may be ultra vires as to both (Boyd v. American Carbon Black Co., (1897) 37 Atl. 937, 182 Pa.St. 206); but the capacity of corporations to contract is a question of corporation law. Under the present law it appears that a partnership can, as such, be a member of another partnership, if that was the intent of the parties. [Raymond v. Putnam, (1862) 44 N.H. 160; Cheap v. Cramond, (1821) 4 Barn. & Ald. 663, 6 E.C.L. 645; In re Hamilton, (1880) 1 Fed. 800; Riddle v. Whitehill, (1890) 10 S.Ct. 924, 135 U.S. 621, 34 U.S. (L.Ed.) 282.]

The words "to carry on as co-owners a business" remove any doubt in the following case: A and B sign partnership articles and make their agreed contributions to the common fund. A refuses to carry on

business as agreed. Is there a partnership to be wound up in accordance with the provisions of Part VI (A.C.A. § 4-42-601 et seq.) "Dissolution and Winding-up"? The words quoted require an affirmative answer to this question. If the words "carrying on business" had been used, in the case given, no partnership would exist, and Part VI (A.C.A. § 4-42-601 et seq.) would not apply.

The definition asserts that the associates are "co-owners" of the business. This distinguishes a partnership from an agency — an association of principal and agent. A business is a series of acts directed toward an end. Ownership involves the power of ultimate control. To state that partners are co-owners of a business is to state that they each have the power of ultimate control.

Lastly, the definition asserts that the business is for profit. Partnership is a branch of our commercial law; it has developed in connection with a particular business association, and it is, therefore, essential that the operation of the act should be confined to associations organized for profit.

In view of the many definitions of a partnership which have been proposed, it is desirable to note the reasons for the omission of certain ideas expressed in some of the definitions cited by Lindley in his work on Partnership, pp. 11, 12.

It is not indicated that the association must be a voluntary one. In the domain of private law the term association necessarily involves the idea that the association is voluntary.

To say that the association must be created by contract is not only unnecessary, but in view of the varied use of the word "contract" in our law, if the word is used an explanation would have to be made as to whether the contract could be

implied, and if so, whether it could be implied in law or only implied as a fact. By merely saying that it is an association these difficulties are avoided.

Again, it is not said that the business must be lawful business. The effect of the unlawfulness of the business is dealt with under Part VI (A.C.A. § 4-42-601 et seq.) "Dissolution and Winding-up." Section 31(3) (A.C.A. § 4-42-603(2)), *infra*, provides that dissolution is produced "By any event which makes it unlawful for the business of the partnership to be carried on or for the members to carry it on in partnership." If the business is wholly unlawful, then the partnership is dissolved the moment it is created. The omission of the word "lawful" in the definition does not prevent this result. Very often, however, a business may be in part lawful and in part unlawful. Hotelkeepers may run a "dive." Placing the word "lawful" before the word business in the definition would tend to throw a doubt on the propriety of the orderly winding up on such a business as a partnership.

Subdivision (2) (A.C.A. § 4-42-201(2)). The reason for not following the English act and attempting to enumerate the associations which are excluded because formed under special statutes, is because such an enumeration is unnecessary, and because the paragraph would have to be differently worded for each state. The paragraph as drawn makes any association formed under a statute a partnership if it would have been a partnership in the state if the act had not been adopted. If the association would not have been a partnership had the act not been adopted, the adoption of the act does not make it a partnership. In short, the adoption of the act does not change the legal status in the state of any association formed under a statute.

### Official Comment to Section 8 (A.C.A. § 4-42-203)

Paragraphs (3) (A.C.A. § 4-42-203(3)), (4) (A.C.A. § 4-42-203(4)), in connection with section 10 (A.C.A. § 4-42-302), *infra*, do away with existing confusions where there has been a conveyance to a partnership in the partnership name, or a conveyance by a partner in the partnership

name. At present such conveyance may convey an equitable, but does not convey a legal title. To this extent paragraph (3) (A.C.A. § 4-42-203(3)) of this section and section 10(1) (A.C.A. § 4-42-302(1)), *infra*, change existing law.



**Official Comment to Section 9 (A.C.A. § 4-42-301)**

The words "including the execution in the partnership name of any instrument" [in subdivision (1) (A.C.A. § 4-42-301(1))] avoid any possible doubt as to whether a partner has the authority, in the ordinary

course of business, to enter into formal contracts for his partnership, or to convey partnership property when the conveyance is the result of a sale in the ordinary course of partnership business.

**Official Comment to Section 10 (A.C.A. § 4-42-302)**

The adoption of this section does away with the existing uncertainty surrounding

the subject of the conveyance of real property belonging to a partnership.

**Official Comment to Section 11 (A.C.A. § 4-42-303)**

Admissions before dissolution concerning a particular matter should bind the partnership only where the partner has authority to act in a particular matter; and after dissolution only if necessary to wind up the business. Where the partner has no authority to act and the person with whom he is dealing knows he has no

authority, or where the admission is made after dissolution and is not for the winding up of partnership affairs, it should not affect the partnership. If it is not the act of the partnership then it should not be evidence against it. The words "within the scope of his authority as conferred by this act" produce this result.

**Official Comment to Section 12 (A.C.A. § 4-42-304)**

At present, there is no confusion in the law when the "notice" is given to the partner while he is a partner. In such cases the effect is the same as if notice was had by all the partners. Where the knowledge or notice has been received by the partner before he became a partner, and his partners are ignorant of this, and he is not the partner acting in the particular matter, there is no doubt that there has been neither knowledge of nor notice to the partnership. Where, however, the partner acting in the particular matter acquired knowledge before he became a partner, and the knowledge is then present in his mind, the weight of authority, and, it is submitted, of reason, appears to be that the partnership should be charged with knowledge. (Mechem on Agency, page 721). The words "acquired while a partner or then present to his mind" effect the result desired.

It is not clear what the present law is when "knowledge," which is not the knowledge that may come from notice, has been obtained by a partner after the formation of the partnership, but the partner having such "knowledge" is not the one acting in the particular matter. It seems clear that in this case the partnership should be charged only when the partner having "knowledge" had reason to believe that the fact related to a matter which had some possibility of being the subject of partnership business, and then only if he was so situated that he could communicate it to the partner acting in the particular matter before such partner gives binding effect to his act. The words "who reasonably could and should have communicated it to the acting partner" accomplish this result.

**Official Comment to Section 15 (A.C.A. § 4-42-307)**

The actual condition of the American statute law affecting the nature of partnership liability is as follows:

In the following states by specific declaration of statutes all partnership liability

is made both joint and several: [Miss. Code (1906), par. 2683; Mo. Stat. Anno. (1906), pars. 889, 892; 2 Ala. Code, par. 2506; N. Mex. Comp. L. (1897), pars. 2894, 2895, 2942, 2943; Md. Gen. Law (1904), p. 1357;

W.Va.Code (1906), pars. 1996, 3467, 3787; D.C.Code (1889), par. 1205; Iowa (1897), pars. 3465, 3468; Gen.Stat. Kansas (1900), par. 1641; Minn.Rev.Laws (1905), pars. 4282, 4283; N.C.Rev.Laws (1905), par. 413; Ark.Statutes, Kirby (1904), pars. 4420, 4422]. In some of these states the liability is merely "deemed to be joint and several for the purpose of the suit." In some of the states referred to the statutes are general; that is, they include all joint liability; while in others, there is the general statement followed by specific enumeration of partnership liability. But in all the states referred to the statutes, taken as a whole, effect, not only partnership liability, but also all joint liability.

In Illinois the court refused to interpret a general statute making all liability joint and several so as to include partnership liability. [Fleming v. Ross, (1907) 225 Ill. 149, 80 N.E. 92, 8 Ann.Cas. 314]; also the courts of Colorado [Erskine v. Russell, (1908) 43 Colo. 449, 453, 96 Pac. 249]. In New York, though the statute apparently made partners liable jointly and severally (3 Cons.L., p. 2522, par. 6), the court refused so to interpret the act [Seligman v. Friedlander, (1910) 138 App.Div. 784, 123 N.Y.S. 583].

In Texas, Oklahoma, Montana, Pennsylvania, New York, Colorado, Illinois, North Dakota, South Dakota, Ohio, Massachusetts, New Jersey, Georgia, Ver-

mont, Virginia, Rhode Island, Kentucky, Michigan, Maine, Connecticut, Idaho and Indiana, partnership liability is joint. In many of these states, however, the results of joint liability as known to the common law have been modified by statute and decision. The extent of the modification varies. In some each partner must be sued severally or all jointly, an election being required. In some the partnership may be sued in the partnership name, and thereafter the partners separately until satisfaction is had. In all the estate of the deceased partner is subject to liability, but in some only after action first had against the survivors; in others proof of no partnership property must first be made; in others proceedings may be first had against the estate.

The purpose of the statutes in those states which have made the liability joint and several was to effect certain procedural results, rather than to affect the substantive law. Where, therefore, a state has already declared the liability to be joint and several, then the principle of uniformity would not be affected by that state so altering this paragraph as to make the liability joint and several, as this change would affect only the procedural law and this act is one to make uniform the substantive law of partnership.

### Official Comment to Section 16 (A.C.A. § 4-42-308)

The section clears several doubts and confusions of our existing case law. It has been held that a person is liable if he has been held out as a partner and knows that he is being held out, unless he prevents such holding out, even if to do so he has to take legal action. (Fletcher v. Pullen, (1889) 16 Atl. 887, 70 Md. 205, 14 Am.St.Rep. 355; Tanner, etc., Engine Co. v. Hall (1888) 5 So. 584, 86 Ala. 305; Rittenhouse v. Leigh, (1850) 57 Miss. 697; Speer v. Bishop, (1874) 24 Ohio St. 598; Prof. Burdick in 30 Cyc. 393.) On the other hand, the weight of authority is to the effect that to be held as a partner he must consent to the holding and that consent is a matter of fact. The act as drafted follows this weight of authority and better reasoning. Morgan v. Farrell, (1890) 20 Atl. 614, 58 Conn. 413, 18 Am.St.Rep. 282; Bishop v. Georgeson, (1871) 60 Ill. 484; Thompson

v. Toledo First Nat. Bank, (1884) 4 S.Ct. 689, 111 U.S. 529, 28 U.S. (L.Ed.) 507; Fisher v. A. Y. McDonald Co., (1899) 85 Ill.App. 653; Ihmsen v. Lathrop, (1883) 104 Pa.St. 365.

Another confusion of our existing case law arises when A is held out with his consent as a partner of B who is in business by himself. Here no partnership in fact exists. Can anyone who relies on the representation have priority on the property in the business over those creditors of B who trusted only B and not A and B? The case of Thayer v. Humphrey, (1895) 64 N.W. 1007, 91 Wis. 276, 51 Am.St.Rep. 887, 30 L.R.A. 549 answers this question in the affirmative. Other cases have reached an opposite conclusion. Burdick, Partnership, p. 16 et seq. Clause (b) affirms this opposite conclusion. In the case put A and B would be liable jointly, but as



there was in fact no partnership fund, the creditors who thought there was in fact no partnership fund, the creditors who thought there was a firm of A and B would

have no priority on the assets which B had in his business as distinguished from his other assets.

### Official Comment to Section 17 (A.C.A. § 4-42-309)

The present section eliminates the difficulty which arises when a new partner is admitted without liquidation of firm debts. The present theory of the common law is that a new partnership is formed; all the property of the partnership which existed up to the moment of the entrance of the new partner being transferred to the new partnership. The result of this theory is that if the business fails, the creditors who have extended credit after the admission of the new partner have a prior claim on the assets in the business. The inequitable character of this result has led to the courts, where no notice of the change of membership is had by the creditors, to be diligent in finding an assumption of liability on the part of the new partnership of the debts of the old partnership.

Though this section changes the formal statement of the law, which is to the effect that an incoming partner is not liable for debts contracted before his admission, as a matter of fact the section as worded conforms to the actual decisions of the courts, which however, are arrived at by making every effort to impress an assumption of liability on the part of the new partnership, formed as a result of the admission of the new partner, of the debts of the old partnership.

The difficulty, which is overcome by this section as worded, is illustrated by the common case where all the property of the existing partnership is taken over, without notice of any break in the conduct of the business, by the new partnership composed of all the members of the existing partnership and the incoming partner; thereby depriving the existing partnership of all its property. Both the existing and the subsequent creditors may believe it is one and the same partnership, but, as

stated, such would not be the case under the present law. There is no peculiar quality in the subsequent creditors giving them a right to be preferred, as against the property employed in the business, to the existing creditors. The incoming partner partakes of the benefit of the partnership property and an established business. He has every means of obtaining full knowledge and protecting himself, because he may insist on the liquidation or settlement of existing partnership debts. The creditors have no means of protecting themselves. So as to preserve the present law as nearly as possible it is declared that the liability of the incoming partner shall be satisfied only out of partnership property. It, therefore, results that existing and subsequent creditors have equal rights as against partnership property and the separate property of all the previously existing members of the partnership, while only the subsequent creditors have rights against the separate estate of the newly admitted partner.

The section should be read in connection with section 41 (A.C.A. § 4-42-613), *infra*. Both sections are based on the principle that where there has been one continuous business the fact that A has been admitted to the business, or C ceased to be connected with it, should not be allowed to cause, as at present, endless confusion as to the claims of the creditors on the property employed in the business; but that all creditors of the business, irrespective of the times when they became creditors and the exact combinations of persons then owning the business, should have equal rights in such property. The recognition of this principle solves one of the most perplexing problems of present partnership law.

**Official Comment to Section 21 (A.C.A. § 4-42-404)**

Subdivision (1) (A.C.A. § 4-42-404(1)) removes a doubt in the existing law. At present it is not clear whether the obligation to account where the partner has money or other property in his hands, is or is not an obligation in the nature of a trust. For instance: A, B and C are partners; A, as a result of a transaction connected with the conduct of the partnership, has in his hands, so that it may be

traced, a specific sum of money or other property. A is insolvent. Is the claim against A a claim against him as an ordinary creditor, or is it a claim to the specific property or money in his hands? The words "and hold as trustee for the partnership any profits" indicate clearly that the partnership can claim as their own any property or money that can be traced.

**Official Comment to Section 22 (A.C.A. § 4-42-405)**

Ordinarily a partner is not entitled to a formal account, except on dissolution. He has equal access with his partners to the partnership books, and there is no reason why they should constantly render to him accounts in the formal sense of the word, which is the sense in which it is here used. When, however, he is excluded from the business or the possession of partnership property, without any express agreement authorizing such exclusion, he should have the right to demand a formal account from his partners, without necessarily requiring him to dissolve the partnership.

The reason for clause (d) is that there

frequently arises circumstances which impose on one or more of the partners the duty of rendering a formal account to the co-partner, as where one partner is traveling for a long period of time on partnership business, and the other partners are in possession of the partnership books. These various circumstances cannot be detailed in any act. In view of the wording of clause (d), the total effect of this section is to emphasize the fact, that a partner, the partnership not being dissolved, has not, necessarily the right to demand formal accounts, except at particular times and under particular circumstances.

**Official Comment to Section 25 (A.C.A. § 4-42-502)**

Subdivision (1) (A.C.A. § 4-42-502(1)). One of the present principal difficulties in the administration of the law of partnerships arises out of the difficulty of determining the exact nature of the rights of a partner in specific partnership property. That the partners are co-owners of partnership property is clear; but the legal incidents attached to the right of each partner as co-owner are not clear. When the English courts in the seventeenth century first began to discuss the legal incidents of this co-ownership, they were already familiar with two other kinds of co-ownership, joint tenancy and tenancy in common. In joint tenancy on the death of one owner his right in the property passes to the other co-owners. This is known as the right of survivorship. The incident of survivorship fits in with the necessities of partnership. On the death of a partner, the other partners and not the executors of the deceased partner should

have the right to wind up partnership affairs. (See clause (d), *infra*.) The early courts, therefore, declared that partners were joint tenants of partnership property, the consequence being that all the other legal incidents of joint tenancy were applied to partnership co-ownership. Many of these incidents, however, do not apply to the necessities of the partnership relation and produce most inequitable results. This is not to be wondered at because the legal incidents of joint tenancy grew out of a co-ownership of land not held for the purposes of business. The attempt of our courts to escape the inequitable results of applying the legal incidents of joint tenancy to partnership has produced very great confusion. Practically this confusion has had more unfortunate effect on substantive rights when the separate creditors of a partner attempt to attach and sell specific partnership property than when a partner attempts to



assign specific partnership property not for a partnership purpose but for his own purposes.

The Commissioners, however, believe that the proper way to end the confusion which has arisen out of the attempt to treat partners as joint tenants, is to recognize the fact that the rights of a partner as co-owner with his partners of specific partnership property should depend on the necessities of the partnership relation. In short, that the legal incidents of the tenancy in partnership are not necessarily those of any other co-ownership.

In the clauses of this section these incidents of tenancy in partnership are stated with several practical results of value. In the first place the law is greatly simplified in expression. In the second place the danger of the courts reaching an inequitable conclusion by refusing to modify the results of applying the legal incidents of joint tenancy to the partnership relation is done away with. Finally, ground is laid for the simplification of a procedure in those cases where the separate creditor desires to secure satisfaction out of his debtor's interest in the partnership. (Compare clause (c) (A.C.A. § 4-42-502(2)(c)) with section 28(1) (A.C.A. § 4-42-505(1)).)

Subdivision (2-b) (A.C.A. § 4-42-502(2)(b)). Clause (b) asserts that the right of a partner as co-owner in specific partnership property is not separately assignable. This peculiarity of tenancy in partnership is a necessary consequence of the partnership relation. If A and B are partners and A attempts to assign all his right in partnership property, say a particular chattel, to C, and the law recognizes the possibility of such a transfer, C would pro tanto become a partner with B; for the rights of A in the chattel are to possess the chattel for a partnership purpose. But partnership is a voluntary relation. B cannot have a partner thrust upon him by A without his, B's, consent.

A cannot confer on C his, A's, right to possess and deal with the chattel for a partnership purpose. Neither can he confer any other rights which he has in the property. A partner has a beneficial interest in a partnership property considered as a whole. As profits accrue, he has a right to be paid on his proportion, and on the winding up of the business, after the obligations due third persons have been met, he has a right to be paid in cash his

share of what remains of the partnership property. These rights considered as a whole are his interest in the partnership; and this beneficial interest he may assign in whole or fractional part, as is indicated in section 27 (A.C.A. § 4-42-504), *infra*. In a sense, each partner, having thus a beneficial interest in the partnership property considered as a whole, has a beneficial interest in each part, and such beneficial interest might be regarded as assignable if it were not impossible, except by purely arbitrary and artificial rules, to measure a partner's beneficial interest in a specific chattel belonging to the partnership, or any other specific portion of partnership property.

A single illustration will make clear the impossibility of determining a partner's beneficial interest in any single piece of partnership property. Let us suppose A and B are partners. The value of partnership property is \$100,000; the liabilities amount to \$50,000. A has contributed \$15,000 and has a three-fourths interest in the profits; B \$10,000 and has one-fourth interest in the profits. A attempts to assign his interest in certain definite chattels belonging to the partnership, the value of these chattels being \$5,000. The chattels themselves must still be used for partnership purposes. On dissolution, if still part of the partnership property, they must be sold. If A conveyed anything, it was not a right in these chattels, but in a fractional part of his interest in the partnership. But how is it to be determined what fractional part of his interest in the partnership A intended to assign? Did he intend to give B a lien for \$5,000 on his interest; or a lien on his interest for three-fourths — his share of profits — of \$5,000? Or did he intend to give him a lien on his interest in the partnership which in amount should bear the same proportion to the total value of the chattel, \$5,000, as the amount which he would receive should the partnership be liquidated, bears to the total of the present partnership property? It is impossible to answer these questions. If the assigning partner did not intend to dissolve the partnership it is even impossible to analyze the possible intentions. Of course, in practice, a partner who assigns his "interest in particular partnership chattels," has only the vaguest notion of what he intends.

Clause (b) (A.C.A. § 4-42-502(2)(b)) not only states a principle theoretically sound,

it expresses almost the unbroken current of authority if we confine our investigation to cases relating to attempted voluntary assignments, as distinguished from involuntary assignment, the result of adverse proceedings by a separate creditor of a partner.

Thus in *Cayton v. Hardy*, (1858) 27 Mo. 536, two were partners in a farm. One, without the consent of the other, sold two yoke of oxen, the property of the partnership used in the work of the farm. He delivered the oxen to the purchaser. The co-partner brought an action against the purchaser and recovered possession. In *Drake v. Thyng*, (1881) 37 Ark. 228, the co-partners, after an assignment by one of his interest in a partnership chattel, recovered possession by a proceeding in equity, and in *McNair v. Wilcox*, (1881) 15 Atl. 575, 121 Pa. St. 437, 6 Am.St.Rep. 799, the co-partners recovered in an action of trover and conversion against a purchaser who refused to return the property. In *Freeman v. Abramson*, (1899) 61 N.Y.S. 839, 30 Misc. 101, the court held that a partner who had "assigned the partnership stock" was a necessary party in a suit for the replevin of the goods brought by the other partners, as the assignment did not deprive the assignee of any interest in the property. These cases are direct authority for the proposition that the attempted assignment of a partnership chattel by a partner, or of his interest in the chattel, does not make the purchaser and the other partners joint tenants or tenants in common of the chattel, for one joint tenant or one tenant in common cannot recover possession from his co-tenant.

An assignment, by way of mortgage, of specific partnership property, the assignment not being an act within the power of the partner creating the mortgage, confers no rights of possession on the mortgagee. *Wilcox v. Jackson*, (1884) 4 Pac. 966, 7 Colo. 521. Nor can such mortgagee prevent the property from being applied to the payment of partnership debts, though thereby all the mortgagee's rights, if any, are destroyed. *McGrath v. Cowen*, (1898) 49 N.E. 338, 57 Ohio St. 385; *Osborne v. Barge*, (1887) 29 Fed. 725. There are, indeed at least two cases which have regarded the partner assigning, by way of mortgage, his interest in specific partnership property as mortgaging something:

*Arnold v. Stevenson*, (1866) 2 Nev. 234; *Sutlive v. Jones*, (1878) 61 Ga. 676; but in neither case did the court indicate how the value of the interest of the partner could be determined.

After an attempted assignment by a partner, invalid as against his copartner, of all the partnership property, it has been held that both partners, as partners, have an insurable interest in the property. *Kimball v. Hamilton F. Ins. Co.*, (1861) 8 Bosw. (N.Y.) 495.

Of course, an attempted assignment of all the partnership property, void as an assignment of the rights of either of the partners in the property, or an attempted assignment by one partner of his rights in all the partnership property, may be regarded as a valid assignment of the partner's interest in the partnership. For instance, in *Nicoll v. Mumford*, (1820) 4 Johns.Ch. (N.Y.) 522, the entire property of the partnership was the brig *Phoenix* and her cargo. One partner assigned "all his estate real and personal," according to a schedule annexed to the deed of assignment, the schedule including the brig *Phoenix* and her cargo. Chancellor Kent regarded the deed as assigning the partner's interest in the partnership. Whatever the merits of this decision, it is not authority for the proposition that a partner's right in one or more of the chattels of the partnership may be separately assigned. It merely stands for the proposition that a particular act — the attempted assignment of the partnership property — was, under the circumstances of that case, an assignment, not of the chattels, the brig and her cargo, but of the interest of the assignor in the partnership. Compare *Horton's Appeal*, (1850) 13 Pa.St. 67. In *Miller v. Brigham*, (1875) 50 Cal. 615, A and B were partners. A "sold and conveyed" to C "all his (A's) one undivided one-half interest in the property." The court was of the opinion, though the question was not directly before them, that A had assigned to C his interest in the partnership. The case does decide that C had no right to possess any of the partnership property.

Against this uniform current of authority we know of only one case where the voluntary assignment by a partner of a chattel belonging to partnership, not being valid as a collective assignment of the rights of all the partners in the property,



nevertheless vested rights in the chattels in the assignee. The case is *Blaker v. Sands*, (1883) 29 Kan. 551. A and B were partners; the business being the improvement of a flock of sheep. In the temporary absence of B, A sold and delivered all the sheep to C. As the partnership was for the improvement, not for the sale of the sheep, their sale was beyond the scope of A as partner. A died, and B brought an action against C for the possession of the sheep. The trial court refused to admit C's offer of the bill of sale of the sheep, and a verdict in favor of B was given. On appeal a new trial was awarded on the theory, that while C's assignment did not transfer the rights of B in the sheep, it made B and C tenants in common, and, therefore, the bill of sale was a defense to B's action and should have been admitted in evidence. The practical result of the decision was to deny to the surviving partner the right to obtain possession of partnership property, though of course he was liable for all the partnership debts. The adoption of clause (b) as drafted would make such a decision impossible.

It will be noted that this clause deals with what may be called the quality of assignability. It asserts that the right in specific partnership property is assignable collectively with the rights of the other partners; or to put the matter in another way, it is possible to assign the rights of all the partners — the rights of the partnership — in partnership property, but it is not possible to assign separately the right of an individual partner.

It is important to note that the clause does not deal with the person or persons who may make an assignment of partnership property, or with the acts necessary to a conveyance of title. Indeed, the act as a whole, except in the case of a conveyance of land belonging to a partnership (see section 11, paragraphs 2, 3, 4, 5, 6)\*, does not attempt to deal with any question pertaining to the transfer of title. The act, however, does deal in section 9(1) (A.C.A. § 4-42-301(1)) with the authority of a partner to bind the partnership. Clause (b) (A.C.A. § 4-42-502(2)(b)) asserts that partnership property as assignable, while section 9(1) (A.C.A. § 4-42-301(1)) indicates when a partner has authority to make an assignment of partnership property; but neither tells us what the partner, in view of what we may call the rules of

conveyancing, must do in order to transfer the title to a stranger, or even whether in view of those rules, it is possible for him, acting alone, to transfer title. For instance, A and B are partners in the retail dry goods business. In the course of the business A sells and delivers to C part of the stock in trade. Clause (b) (A.C.A. § 4-42-502(2)(b)) indicates that the rights of A and B in the goods are collectively assignable: section 11(1)\* that A had the authority to make the sale and deliver the goods. But whether a good title has, by the sale and delivery, been vested in C is a question pertaining to the transfer of title to chattels. Delivery passes the title of the owner when the delivery is by the owner or with his consent. C, therefore, in the case put, obtains a good title. It is no part of the business of a partnership act, however, to deal with such a question; unless, as in the case of land, it is considered desirable to introduce a new method of transfer of title, or to make clear confusions in the law, which confusions exist only in cases connected with property held by a partnership. In all other cases, as in the illustration given, the requirements of a partnership act are satisfied if the co-ownership of partnership property is stated, the collective assignability of the rights of all the partners emphasized, and the extent of the agency of the partner to act for his co-partners indicated.

The importance of seeing clearly the exact scope of clause (b) (A.C.A. § 4-42-502(2)(b)) warrants two additional illustrations. If A, in the case above put, instead of selling and delivering part of the stock, should attempt to sell and should deliver a counter or table on which the goods were sold, would the purchaser obtain a good title? Clause (b) (A.C.A. § 4-42-502(2)(b)) does not answer this question. It merely states that the table being partnership property, the rights of all the partners in it are subject to collective assignment. This is what A has attempted to do. But the clause does not tell us whether A had, under the circumstances, power to make the assignment or whether, having the power he has done so. Neither does section 11(1)\* answer either of these questions. Section 11(1)\* tells us that A has, under the circumstances, no authority to bind the partners, as the act is not an act for apparently carrying on in the usual way the business of the partner-

ship. But whether A has the power to make the conveyance depends on the law of transfer of title to chattels — a subject beyond the scope of the act. Under ordinary circumstance, C would obtain no title to B's rights, as it is a fundamental rule pertaining to the transfer of titles to chattels that the right of the true owner is not transferred by the sale and delivery of an agent in possession, unless the owner has done something to clothe the agent with the apparent power of sale, the delivery of the chattel by the owner to the agent or bailee not being considered such an act.

Finally, suppose A and B are in partnership, the business of the partnership being the buying and selling of land. The title to a particular tract is in A and B. A sells X to C, giving C a deed signed by A but not by B. The land being partnership property the rights of A and B are collectively assignable. A has attempted to make such an assignment. The business of the partnership being "trading in land" the sale was an act which the partner had authority to do. But whether the deed signed by one partner only in his own name conveyed to B title is again a question of conveyancing, and normally outside the province of a partnership act. In this case, however, section 11(4)\* does deal with the transfer of the equitable title, declaring that it is, under the circumstances, vested in C.

Subdivision (2-c) (A.C.A. § 4-42-502(2)(c)). Compare this clause with section 28(1) (A.C.A. § 4-42-505(1)).

The first sentence in this clause is similar to section 23(1) (A.C.A. § 4-42-406(1)) of the English Act. It is a logical consequence of clause (b) (A.C.A. § 4-42-502(2)(b)). If a partner's right in specific partnership property is not assignable by voluntary assignment for a separate purpose of the assignment partner, his sepa-

rate creditors should not be able to force an involuntary assignment. The beneficial rights of the separate creditors of a partner in partnership property should be no greater than the beneficial rights of their debtor. The confusion of the subject of this clause in the decisions is well known to all students of the law of partnership. For all practical purposes, while the reasoning of the courts is more or less conflicting, the net result of the remedial law, as worked out in law and at equity, is that a judgment creditor of a separate partner may attach and sell his debtor's interest in partnership property as that interest is defined in section 26 (A.C.A. § 4-42-503) (see section 28 (A.C.A. § 4-42-505)); but he cannot sell so as to affect in any way the rights of the partnership specific partnership property. [See *Heydon v. Heydon*, (1693) 1 Salk. 392; *Eddie v. Davidson*, (1781) 2 Dougl. 650; *Taylor v. Fields*, (1799) 4 Ves.Jr. 396; *Lord v. Baldwin*, (1828) 6 Pick. (Mass.) 348; *Doner v. Stauffer*, (1829) 1 Pen. & W. (Pa.) 198, 21 Am.Dec. 370; *Tappen v. Blaisdell*, (1830) 5 N.H. 190; *Phillips v. Cook*, (1840) 24 Wend. (N.Y.) 389; *Washburn v. Bellows Falls Bank*, (1847) 19 Vt. 278; *Nixon v. Nash*, (1861) 12 Ohio St. 647, 80 Am.Dec. 390; *Cooper's Appeal*, (1856) 26 Pa.St. 262; *Menagh v. Whitwell*, (1873) 52 N.Y. 146, 11 Am.Rep. 683; *Case v. Beauregard*, (1878) 99 U.S. 119, 25 U.S. (L.Ed.) 370.]

The second sentence in the paragraph apparently expresses the weight of authority. (See *Burdick* 111-113, 299.) A partner has right to claim exemption if his interest in the partnership is attached for his separate debts. [See section 28(3) (A.C.A. § 4-42-505(3)), *infra*.]

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\*Incorrect reference since § 11 does not have numbered paragraphs.

### Official Comment to Section 27 (A.C.A. § 4-42-504)

In re the subject of this paragraph, [subd. 1 (A.C.A. § 4-42-504(1))] see [George, 153; Beale's Parsons, sections 106, 305, 306; Story, sections 272, 377, 308; Bates, sections 158-168, 931-933; Lindley, 397 et seq., 620; Jas. Parsons, section 175; Collyer 151, 161; Kent, 59]. These authorities on the whole state that the mere assignment dissolves the part-

nership. Many such assignments, however, are merely by way of collateral security for a loan, the assigning partner in no wise intending to end the partnership relation. If he neglects his personal relation the other partners may dissolve the partnership under section 31 (A.C.A. § 4-42-603) of this act. But the mere fact of assignment without more should not be



said in all cases to be an act of dissolution. The change in the existing law follows a similar change of the English law embod-

ied in section 31 of the English Partnership Act.

### Official Comment to Section 28 (A.C.A. § 4-42-505)

This provision [subdivision (1) (A.C.A. § 4-42-505(1))] is taken from section 23(2) of the English Partnership Act. The operation of the provision has given great satisfaction. The judgment creditor does not acquire any greater rights than the

debtor is entitled to for his own benefit. [Sutton v. English, etc., Produce Co., [1902] 2 Ch. 502; Howard v. Sadler, [1893] 1 Q.B. 1; Cooper v. Griffin, [1892] 1 Q.B. 740; Scott v. Hastings, (1858) 4 Kay & J. 633].

### Official Comment to Section 29 (A.C.A. § 4-42-601)

As used by the legal profession the term "dissolution" designates, not only the single act of the termination of the actual conduct of the ordinary business, but also often the series of acts thereafter until the final settlement of all partnership affairs. It is also frequently said that dissolution, although the word is used to designate only the termination of ordinary business relations, terminates the partnership, it being at the same time explained that the partnership thereafter continues to exist

for the purpose of suing and being sued in the process of winding up partnership affairs. Certainty demands that this confusion should be removed if possible. In this act dissolution designates the point in time when the partners cease to carry on the business together; termination is the point in time when all the partnership affairs are wound up; winding up, the process of settling partnership affairs after dissolution.

### Official Comment to Section 31 (A.C.A. § 4-42-603)

Paragraph (2)\* will settle a matter on which at present considerable confusion and uncertainty exists. The paragraph as drawn allows a partner to dissolve a partnership in contravention of the agreement between the partners. This is supported by the weight of authority. [Cal.Civ.Code, section 2417; S.Dak.Civ. Code, section 1736; Okla.C.C., section 4850; No.Dak.C.C., section 5848; Mont.C.C., section 3262; Ga.C.C., section 2633; Skinner v. Dayton, (1822) 19 Johns. (N.Y.) 513, 537, 10 Am.Dec. 286; Mason v. Connell, (1836) 1 Whart. (Pa.) 381, 388; Monroe v. Conner, (1838) 15 Me. 178, 32 Am.Dec. 148; Cape Sable Co.'s Case, (1832) 3 Bland (Md.) 606, 674; Slemmer's Appeal, (1868) 58 Pa.St. 168, 176, 98 Am.Dec. 255; Solomon v. Kirkwood, (1884) 21 N.W. 336, 55 Mich. 256; Carr v. Hertz, (1895) 33 Atl. 194, 54 N.J.Eq. 127; Moore v. Price, (1896) 22 So. 531, 116 Ala. 247; Karrick v. Hannaman, (1897) 18 S.Ct. 135, 168 U.S. 328, 334, 442 U.S. (L.Ed.) 484; Lapenta v. Lettieri (1899) 44 Atl. 730, 72 Conn. 377,

77 Am.St.Rep. 315; Clements v. Norris (1878) 8 Ch.D. 129, 133. The English law is opposed to this view. Lindley 601; Crawshay v. Maule, (1818) 1 Swanst. 495, 509; Featherstonhaugh v. Fenwick, (1810) 17 Ves.Jr. 298; Peacock v. Peacock, (1809) 16 Ves.J. 49; Ferrero v. Buhlmeyer, (1867) 34 How.Pr. (N.Y.) 33; Story, section 275.]

The relation of partners is one of agency. The agency is such a personal one that equity cannot enforce it even where the agreement provides that the partnership shall continue for a definite time. The power of any partner to terminate the relation, even though in doing so he breaks a contract, should, it is submitted, be recognized.

The rights of the parties upon a dissolution in contravention of the agreement are safeguarded by section 38(2) (A.C.A. § 4-42-610(2)), *infra*.

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\*Language adopted in the Arkansas Code is different from the Uniform Act.

**Official Comment to Section 34 (A.C.A. § 4-42-606)**

This section relates only to a partner's liability to his co-partner, where a co-partner, after dissolution, caused by the act of one of the parties or by the death or bankruptcy of a partner, makes a contract in the course of partnership business.

As worded, where the dissolution has been caused by the act of one of the parties, if the partner acting is subject to a liability to third persons, he can call on his co-partners to contribute towards this liability to the same extent as if there had been no dissolution, provided he had no knowledge of the dissolution, at the time of the act. Mere notice not producing knowledge, would not be sufficient. This provision makes certain that which is now uncertain. Thus A, B and C are partners. A, in accordance with his right, or in contravention of the agreement between the partners, declared a dissolution of the partnership. B, subsequently, makes a contract for the partnership in ignorance of the dissolution. B under this act would have the right to call upon A and C to assume their share of the burden. The Commissioners believe that to relieve A and C of this duty to B, B ought to have more than "notice" as "notice" is defined in section 3 (A.C.A. § 4-42-103), *supra*. "Notice" should be, it is submitted, sufficient in all cases where the fact to be notified is an ordinary business fact, as notice to third persons of the dissolution of a partnership. But it is not customary for partners to dissolve a partnership at a time not previously specified, without consultation with their co-partners. Such dissolution may or may not amount to a breach of partnership contract; but in any event, if done without consultation, it is out of the ordinary course. This fact should not deprive the partner of a right to terminate a relationship which must necessarily depend on mutual good will and confidence; but if the partner so terminating wishes to show that he should not be required by his partners to be liable for his share of the loss due to a partnership contract thereafter made by them, he should be able to prove that they had "knowledge" that he had dissolved the partnership at the time they made the contract.

Clause (b) (A.C.A. § 4-42-606(b)) makes a change in the law. [Beale's Parsons,

sections 309, 310, 318, 342, 343, 351; Mechem, sections 245, 258, 259, 260, 261, 266; Collyer, sections 102, 103; 30 Cyc. 653, 670; Story, sections 265 et seq., 319, 334, 336; Bates, 570 et seq.; Conyngton, sections 53, 72; Burdick, 56; Shumaker, sections 119, 120; 3 Kent. Comm. 53.] At present where the partnership is terminated by operation of law, i.e., by death, bankruptcy, by being unlawful, or by decree of court, every person "must take" notice of such facts. This statement is made generally and includes the partners. As to the partners, to whom only this provision relates, the Commissioners agree that they must not expect relief if the partnership or the business is unlawful, or if they have actual knowledge or notice of dissolution by decree of court; but the Commissioners do not believe that the partners do have actual knowledge or should "take notice" of the death or of the bankruptcy of any one partner. In the case of death to hold that a partner acting for the partnership bona fide in ignorance of the death of one of his co-partners must assume the entire liability, even though all other partners are ignorant of the death of the partner, and even though such deceased partner was entirely inactive and may have resided at any distance from the actual place of business, is entirely unjust to the acting partner or partners. The rule of the common law has been modified as to the law of agency. [Story on Agency, (1882) 598; *Cassiday v. McKenzie*, (1842) 4 Watts & S. (Pa.) 282, 39 Am. Dec. 76, section 185; Cal.C.C., section 2356; Dak.C.C., sections 1150, 1151; Md.Rev.Code, (1878) 388 art. 44, section 31; *Saunders's Rev.Civ.Code of La.*, (1909) section 3032; S.C.Gen.Stat., (1882) section 1302; Kent. Comm. 646; Mechem on Agency, section 245; *Blackwood Wright* (2d Ed.Eng.) on Principal and Agent, 332 et seq.; *English Conveyancing Act*, (1881) section 47; *English Bankruptcy Act*, (1883) section 38. See *Lindley*, 240 et seq.] The Commissioners believe that the partnership law should follow this modification.

What has been said of the death of a partner applies also to the bankruptcy of a partner. If there are a number of partners, and one of them becomes bankrupt, and



another having no knowledge or notice of this fact makes a contract in the ordinary course of business, there appears no reason why he should not be able to call on

his other partners, not bankrupt or deceased, to contribute towards any loss which his separate estate may sustain on account of the contract.

### Official Comment to Section 35 (A.C.A. § 4-42-607)

At present in most jurisdictions it is doubtful whether, under the circumstances set forth in (b), "the other party" can bind the partnership where such party has no knowledge or notice of the dissolution and has had business transactions with the partnership before the dissolution, but these business transactions have not involved any extension of credit to the partnership.

In support of the provision, as written, see Beale's Parsons, section 319; Mechem, section 262; Burdick, 57; 2 Bates, sections 613, 614; 30 Cyc. 671; Cal.C.C., section

2453. There is also authority for merely requiring that "the other party" shall have had business transactions with the partnership. James Parsons, sections 179, 180, 181; Lindley, 249; Pollock, 98; 3 Kent. Comm., 67; Collyer, 163n; Shumaker, section 121; Mechem, 261, 262; Bates 612, 613.

The practical impossibility of the partners knowing, by any feasible system of bookkeeping, all the persons with whom they have had dealings, unless credit has been extended, supports the wording adopted by the Commissioners.

### Official Comment to Section 38 (A.C.A. § 4-42-610)

The right given to each partner, where no agreement to the contrary has been made, to have his share of the surplus paid to him in cash makes certain an existing uncertainty. At present it is not

certain whether a partner may or may not insist on a physical partition of the property remaining after third persons have been paid.

### Official Comment to Section 40 (A.C.A. § 4-42-612)

The adoption of this clause [subd. (a) II (A.C.A. § 4-42-612(a)(II))] will end the present confusion as to whether the contribution of the partners towards the losses of the partnership are partnership assets or not. [See *In re Bertenshaw*, (1907) 157 Fed. 363, 85 C.C.A. 61, 13 Ann.Cas. 986, 17 L.R.A.(N.S.) 886; *In re Forbes*, (1904) 128 Fed. 137; *Barry v. Foyles*, (1828) 1 Pet. 311, 7 U.S. (L.Ed.)

157; *George M. West Co. v. Lea*, (1899) 19 S.Ct. 836, 174 U.S. 590, 43 U.S. (L.Ed.) 1098; *Vaccaro v. Security Bank*, (1900) 103 Fed. 436, 43 C.C.A. 279; *In re Mercur*, (1903) 122 Fed. 384, 58 C.C.A. 472.] The Commissioners believe that the opinion that such contributions are assets is supported by the better reasoning. See *In re Forbes*.

### Official Comment to Section 41 (A.C.A. § 4-42-613)

Subdivision (1) (A.C.A. § 4-42-613(1)). As originally passed by the Conference, paragraph 1 of section 41 reads as follows:

"When any partner retires and assigns (or the representative of a deceased partner assigns) his rights in partnership property to two or more of the partners, or to one or more of the partners and one or more third persons, who continue the business without liquidation of the partnership affairs, creditors of the dissolved

partnership are also creditors of the partnership so continuing the business."

It was subsequently pointed out that section 41 did not cover the situation which arises when a partnership is dissolved and a new partnership formed by the introduction of a new partner into the business without the liquidation of the affairs of the first partnership, and that it would be best not to rely on section 17 (A.C.A. § 4-42-309), *supra*, to take care of

the situation. The paragraph, reworded as now printed, was submitted to the Commissioners present at the last Conference and they have signified their approval of the change.

The section as a whole deals primarily with the rights of creditors when a new partner is admitted or a partner retires, is expelled or dies, and the business is continued without liquidation of the debts of the partnership dissolved by the change in personnel.

At present the whole subject is in doubt and confusion. It is universally admitted that any change in membership dissolves a partnership, and creates a new partnership. This section as drafted does not alter that rule. Neither does it alter the rule that on any change of personnel the property of the dissolved partnership becomes the property of the partnership continuing the business. At present, however, creditors of the dissolved partnership do not become creditors of the new partnership. Thus, if A, B and C are partners and A assigns to B and C, who continue the business without any agreement to pay the partnership debts, under the present law the property of the first partnership becomes the property of the second partnership, but the creditors of the first partnership are not the creditors of the second partnership, though they are the creditors of all of the members of that partnership. Such creditors, therefore, are often unable to secure satisfaction of their claims, though at the time of the assignment the partnership was solvent, and the business may have been continued by the second partnership without any notification of the change in membership. On the other hand, the creditors of the second partnership may be paid in full out of the property. This inequitable result the courts have attempted, in not a few instances, to prevent, by declaring that the assignment of the property of the first partnership to the second partnership was a fraud on the creditors of the first partnership, though no fraud was intended, the result being that the creditors of the second partnership are postponed until the creditors of the first partnership are paid in full.

The paragraph as drawn changes the law in the case supposed, and, thereby, does away with an injustice. In making the creditors of the first partnership creditors of the second it prevents such an

assignment from affecting the rights of partnership creditors in the property embarked in the business.

Again, in the case supposed, if B and C promise to pay the debts of the partnership of A, B and C, it is uncertain whether the court will hold that they promise as individuals or as a new partnership. If as individuals the old partnership creditors are not creditors of the new partnership. If A and B considered as promising as a new partnership, then, whether the old partnership creditors can sue the new partnership as beneficiaries depends on the jurisdiction. The paragraph as drawn ends this uncertainty. In every case the creditors of the first partnership become creditors of the second; though, of course, they do not cease to be creditors of the first partnership. As, however, the first partnership has assigned all its property, this is of little value to such creditors, unless the assignees have promised the retiring partner an additional consideration beyond the payment of the debts. The status of such additional consideration is treated in paragraph (8) (A.C.A. § 4-42-613(8)), *infra*.

The paragraph as a whole, as well as this entire section, is based on the opinion that when there is a continuous business carried on first by A, B and C, and then by A, B, C and D, or by B or C, or by B and C, by B and D, or by C and D, or by B, C and D, without any liquidation of the affairs of A, B, C, both justice and business convenience require that all the creditors of the business, irrespective of the exact grouping of the owners at the times their respective claims had their origin, should be treated alike, all being given an equal claim on the property embarked in the business. (Compare note to section 17 (A.C.A. § 4-42-309), *supra*.)

Subdivision (2) (A.C.A. § 4-42-613(2)). Where all the partners assign to one partner, the partnership creditors are, under this paragraph, the separate creditors of the partner continuing the business, where he continues the business alone, whether such partner promises to pay the debts of the dissolved partnership or not. If he takes one or more new partners and they continue the business with the property of the dissolved partnership, the creditors of the dissolved partnership are the creditors of the partnership continuing the business. This paragraph changes the



present law to the same extent as paragraph (1) (A.C.A. § 4-42-613(1)).

Subdivision (3) (A.C.A. § 4-42-613(3)). The paragraph extends the principle of the first and second paragraphs of the section to the case where the business is continued by two or more of the partners, alone or with others, after the retirement or death of a partner without any formal assignment to them of the retired or deceased partner's rights in partnership property. The neglect of the retiring partners or of the representatives of the deceased partner should not as at present create inexecutable confusion between the creditors of the first and second partnership in regard to their respective rights in the property employed in the business. Both classes of creditors should be ahead of the claim of such retired partner or the representative of the deceased partner, and both classes of creditors should also have equal rights in the property. This paragraph probably effects a change in the present law, though the same result is often now brought about by implying a promise to pay debts of the dissolved partnership on the part of the person or partnership continuing the business.

Subdivision (4) (A.C.A. § 4-42-613(4)). The existing law in relation to the subject matter covered by this paragraph is so uncertain that it is not possible to say whether its adoption would modify the law. The paragraph does not apply to the case where the third person or persons do not promise to pay the debts of the dissolved partnership. In that case the creditors of the dissolved partnership have no claim on the partnership continuing the business or its property unless the assignment can be set aside as a fraud on creditors, or is affected by a Sales in Bulk Act. Where, however, there has been a promise to pay the debts of the dissolved partnership, then, the creditors of the dissolved partnership are not only creditors of the promisor or promisors — which, in the United States, they would be as beneficiaries — but under this paragraph, if the business of the dissolved partnership is continued by a partnership, the creditors of the dissolved partnership become creditors of the partnership continuing the business, not merely the separate or joint creditors of the partners in such partnership.

Subdivision (7) (A.C.A. § 4-42-613(7)). The paragraph merely reiterates the principle of section 17 (A.C.A. § 4-42-309), *supra*, which is that an incoming partner should be liable for the existing debts of the partnership, but that this liability should be limited to his right in partnership property. Though in cases under this section the person who joins the business on the dissolution of the first partnership is not an incoming partner, because the first partnership is dissolved. Under the circumstances, his liability for the debts of the business contracted before his admission should be the same as that in an incoming partner, if confusion is to be avoided in respect to the rights in the property employed in the business, between the creditors who were creditors before he joined the business and those who became creditors afterwards.

Subdivision (8) (A.C.A. § 4-42-613(8)). Suppose A, B and C are partners and A retires, assigning his interest to B and C, who continue the business with the property of the dissolved partnership, promising to pay A \$2,000. On the subsequent failure of both partnerships under paragraph (1) (A.C.A. § 4-42-613(1)) of this section, the creditors of the first partnership would be also creditors of the second. By the assignment the property employed in the business would be the property of the second partnership. By this contract A would be a creditor of the second partnership for \$2,000; but this claim, A being insolvent, would belong under the wording of this paragraph, not to A's separate estate, but to the creditors of the first partnership.

The uncertainty of existing law renders it impossible to say whether the adoption of this paragraph would change the law. The Commissioners believe that certainty of the law is essential, and that the rule stated in the paragraph is sound. A, in the case put, has sold his property rights in the partnership before settling with the creditors of the partnership, and therefore, those creditors should have an equitable lien on the consideration of the sale as against the separate creditors of the retiring partner, or as against the representatives of a deceased partner who have sold the rights of their decedent to the persons continuing the business.

**REVISED LIMITED PARTNERSHIP ACT (1987)  
WITH THE 1985 AMENDMENTS  
(A.C.A. § 4-43-101 ET SEQ.)**

**Prefatory Note**

In 1976, the National Conference of Commissioners on Uniform State Laws adopted the first revision of the Uniform Limited Partnership Act, originally promulgated in 1916. The 1976 Act was intended to modernize the prior uniform law while retaining the special character of limited partnerships as compared with corporations. The draftsman of a limited partnership agreement has a degree of flexibility in defining the relationships among the partners that is not available in the corporate form. Moreover, the relationship among partners is consensual, and under some circumstances may require a general partner to seek approval of the other partners (sometimes unanimous approval) under circumstances that corporate management would find unthinkable. The limited partnership was not intended to be an alternative in all cases where the corporate form is undesirable for tax or other reasons, and the 1976 Act was not intended to make it so. The 1976 Act clarified many ambiguities and filled interstices in the 1916 Act by adding more detailed language and mechanics. In addition, it effected some important substantive changes and additions from the prior uniform law.

The Uniform Limited Partnership Act (1976) with the 1985 Amendments (the 1985 Act) follows the 1976 Act very closely in most respects. It makes almost no change in the basic structure of the 1976 Act. It does, however, differ from the 1976 Act in certain significant respects for the purpose of more effectively modernizing, improving, and establishing uniformity in the law of limited partnerships. The 1985 Act accomplishes this, without impairing the basic philosophy or values underlying the 1976 Act, by incorporating into the structure, framework, and text of the 1976 Act the best and most important improvements that have emerged in the limited partnership acts enacted recently by certain states. Most of those improvements were considered by the draftsmen of the

1976 Act but were not included in it because of uncertainties as to the possible consequences of such inclusion under applicable Federal income tax laws. Those uncertainties have since been resolved satisfactorily, and no impediment to incorporating them in the 1985 Act remains at this time.

Article 1 (A.C.A. § 4-43-101 et seq.) provides a list of all of the definitions used in the Act, integrates the use of limited partnership names with corporate names and provides for an office and agent for service of process in the state of organization. All of these provisions were innovations in the 1976 Act and were carried over from the 1976 Act to the 1985 Act. Article 2 (A.C.A. § 4-43-201 et seq.) collects in one place all provisions dealing with execution and filing of certificates of limited partnership and certificates of amendment and cancellation. When adopted in 1976, Articles 1 and 2 (A.C.A. § 4-43-101 et seq. and § 4-43-201 et seq.) reflected an important change in the prior statutory scheme: recognition that the basic document in any partnership, including a limited partnership, is the partnership agreement. The certificate of limited partnership is not a constitutive document (except in the sense that it is a statutory prerequisite to creation of the limited partnership), and merely reflects the most basic matters as to which government officials, creditors, and others dealing or considering dealing with the partnership should be put on notice. This principle is further implemented by the 1985 Act's elimination of the requirement, carried from the original 1916 Act into the 1976 Act, that the certificate of limited partnership set out the name, address, and capital contribution of each limited partner and certain other details relating to the operation of the partnership and the respective rights of the partners. The former requirement served no significant practical purpose while it imposed on limited partnerships (particularly those hav-



ing large numbers of partners or doing business in more than one state) inordinate administrative and logistical burdens and expenses connected with filing and amending their certificates of limited partnership. Many of the other changes made by the 1985 Act merely reflect the elimination of that requirement.

Article 3 (A.C.A. § 4-43-301 et seq.) deals with the single most difficult issue facing lawyers who use the limited partnership form of organization: the powers and potential liabilities of limited partners. Section 303 (A.C.A. § 4-43-303) lists a number of activities in which a limited partner may engage without being held to have so significantly participated in the control of the business that he acquires the liability of a general partner. Moreover, it goes on to confine the liability of a limited partner who merely participates in control to situations in which persons who actually know of that participation in control are misled thereby to their detriment into reasonably believing the limited partner to be a general partner. This "detrimental reliance" test, together with an expansion of the "laundry list" of specific activities in which limited partners may participate without incurring liability, are among the principal innovations in the 1985 Act.

The provisions relating to general partners are collected in Article 4 (A.C.A. § 4-43-401 et seq.). It differs little from the corresponding article in the 1976 Act, except that some of the 1976 Act's references to the certificate of limited partnership have been changed to refer instead to the partnership agreement. This is in recognition of the principle that the limited partnership agreement, not the certificate of limited partnership, is the primary constitutive, organizational, and governing document of a limited partnership. Article 5 (A.C.A. § 4-43-501 et seq.), dealing with finance, differs in some important respects from Article 5 of the 1976 Act, which itself made some important changes from the 1916 Act. The 1976 Act explicitly permitted contributions to the partnership to be made in the form of the contribution of services and promises to contribute cash, property, or services, and provided that those who failed to perform promised services were required, in the absence of an agreement to the contrary, to pay the value of the services as stated

in the certificate of limited partnership. These important innovations of the 1976 Act are retained in substance in the 1985 Act. However, the 1985 Act substitutes the partnership agreement and the records of the limited partnership for the certificate of limited partnership as the place such agreements are to be set out and such information is to be kept.

Article 6 of the 1976 Act\*, dealing with distributions and with the withdrawal of partners from the partnership, made a number of changes from the 1916 Act. For example, Section 608\*\* created a statute of limitations applicable to the right of a limited partnership to recover all or part of a contribution that had been returned to a limited partner, whether to satisfy creditors or otherwise. The 1985 Act retains these features of the 1976 Act without substantive change.

In both the 1976 and the 1985 Acts, the assignability of partnership interests is dealt with in considerable detail in Article 7 (A.C.A. § 4-43-701 et seq.), and the provisions relating to dissolution appear in Article 8 (A.C.A. § 4-43-801 et seq.). Article 8 of the 1976 Act established a new standard for seeking judicial dissolution of a limited partnership, which standard is carried forward into the 1985 Act.

Article 9 (A.C.A. § 4-43-901 et seq.) of the 1976 and 1985 Acts deals with one of the thorniest questions for those who operate limited partnerships in more than one state, i.e., the status of the partnership in a state other than the state of its organization. Neither case law under the 1916 Act nor administrative practice made it clear which state's law governed the partnership or whether, in that other state, the limited partners continued to possess limited liability. Article 9 of the 1976 Act dealt with this problem by providing for registration of foreign limited partnerships and specifying choice-of-law rules. Article 9 (A.C.A. § 4-43-901 et seq.) of the 1985 Act retains all of those basic provisions and innovations of the 1976 Act.

Article 10 of the 1976 Act represented another significant innovation, by authorizing derivative actions to be brought by limited partners. The 1916 Act failed to address this entire concept. Article 10 (A.C.A. § 4-43-1001 et seq.) of the 1985 Act clarifies certain provisions of the 1976 Act but does not make any substantive

changes in the corresponding provisions of the 1976 Act.

Finally, Article 11 (A.C.A. § 4-43-1101 et seq.) sets out a number of miscellaneous provisions, not the least of which are those dealing with the application of the new statute to limited partnerships in existence at the time of its enactment. Those provisions in the 1976 Act were expanded upon by the 1985 Act to give greater deference to the possible expectations, some of which may have constitu-

tionally protected status, of partners in such limited partnerships concerning the continuing applicability to their partnerships of the law in effect when they were organized.

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\*Article 6 of the 1985 Act is codified as § 4-43-601 et seq.

\*\*Section 608 of the 1985 Act is codified as § 4-43-608.

### Comment to Section 101 (A.C.A. § 4-43-101)

The definitions in this section clarify a number of uncertainties in the law existing prior to the 1976 Act, and also make certain changes in such prior law. The 1985 Act makes very few additional changes in Section 101 (A.C.A. § 4-43-101).

**Contribution:** this definition makes it clear that a present contribution of services and a promise to make a future payment of cash, contribution of property or performance of services are permissible forms for a contribution. Section 502 (A.C.A. § 4-43-502) of the 1985 Act provides that a limited partner's promise to make a contribution is enforceable only when set out in a writing signed by the limited partner. (This result is not dissimilar from that under the 1976 Act, which required all promises of future contributions to be described in the certificate of limited partnership, which was to be signed by, among others, the partners making such promises). The property or services contributed presently or promised to be contributed in the future must be accorded a value in the partnership agreement or the partnership records required to be kept pursuant to Section 105 (A.C.A. § 4-43-105), and, in the case of a promise, that value may determine the liability of a partner who fails to honor his agreement (Section 502) (A.C.A. § 4-43-502). Section 3 of the 1916 Act did not permit a limited partner's contribution to be in the form of services, although that inhibition did not apply to general partners.

**Foreign limited partnership:** the Act only deals with foreign limited partnerships formed under the laws of another "state" of the United States (see subdivi-

sion 12 of Section 101) (A.C.A. § 4-43-101(12)), and any adopting state that desires to deal by statute with the status of entities formed under the laws of foreign countries must make appropriate changes throughout the Act. The exclusion of such entities from the Act was not intended to suggest that their "limited partners" should not be accorded limited liability by the courts of a state adopting the Act. That question would be resolved by the choice-of-law rules of the forum state.

**General partner:** this definition recognizes the separate functions of the partnership agreement and the certificate of limited partnership. The partnership agreement establishes the basic grant of management power to the persons named as general partners; but because of the passive role played by the limited partners, the separate, formal step of memorializing that grant of power in the certificate of limited partnership has been preserved to emphasize its importance and to provide notice of the identity of the partnership's general partners to persons dealing with the partnership.

**Limited partner:** unlike the definition of general partners, this definition provides for admission of limited partners through the partnership agreement alone and does not require identification of any limited partner in the certificate of limited partnership (Section 201) (A.C.A. § 4-43-201). Under the 1916 and the 1976 Acts, being named as a limited partner in the certificate of limited partnership was a statutory requirement and, in most if not all cases, probably also a prerequisite to limited partner status. By eliminating the requirement that the certificate of limited partnership contain the name, address,



and capital contribution of each limited partner, the 1985 Act all but eliminates any risk that a person intended to be a limited partner may be exposed to liability as a general partner as a result of the inadvertent omission of any of that information from the certificate of limited partnership, and also dispenses with the need to amend the certificate of limited partnership upon the admission or withdrawal of, transfer of an interest by, or change in the address or capital contribution of, any limited partner.

**Partnership agreement:** the 1916 Act did not refer to the partnership agreement, assuming that all important matters affecting limited partners would be set forth in the certificate of limited partnership. Under modern practice, however, it has been common for the partners to enter into a comprehensive partnership

agreement, only part of which was required to be included or summarized in the certificate of limited partnership. As reflected in Section 201 (A.C.A. § 4-43-201) of the 1985 Act, the certificate of limited partnership is confined principally to matters respecting the partnership itself and the identity of general partners, and other important issues are left to the partnership agreement. Most of the information formerly provided by, but no longer required to be included in, the certificate of limited partnership is now required to be kept in the partnership records (Section 105) (A.C.A. § 4-43-105).

**Partnership interest:** this definition first appeared in the 1976 Act and is intended to define what it is that is transferred when a partnership interest is assigned.

#### **Comment to Section 102 (A.C.A. § 4-43-102)**

Subdivision (2) of Section 102 (A.C.A. § 4-43-102(2)) has been carried over from Section 5 of the 1916 Act with certain editorial changes. The remainder of Section 102 (A.C.A. § 4-43-102) first appeared in the 1976 Act and primarily reflects the intention to integrate the registration of limited partnership names with that of corporate names. Accordingly, Section 201 (A.C.A. § 4-43-201) provides for central, state-wide filing of certificates of limited partnership, and subdivisions (3) (A.C.A. § 4-43-102(3)) and (4)\* of Section 102 (A.C.A. § 4-43-102) contain standards to be applied by the filing officer in

determining whether the certificate should be filed. Subdivision (1) (A.C.A. § 4-43-102(1)) requires that the proper name of a limited partnership contain the words "limited partnership" in full. Subdivision (3) of the 1976 Act has been deleted, to reflect the deletion from Section 201 (A.C.A. § 4-43-201) of any requirement that the certificate of limited partnership describe the partnership's purposes or the character of its business.

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\*Arkansas has not adopted subdivision (4).

#### **Comment to Section 103 (A.C.A. § 4-43-103)**

Section 103 (A.C.A. § 4-43-103) first appeared in the 1976 Act. The 1916 Act did not provide for registration of names.

#### **Comment to Section 104 (A.C.A. § 4-43-104)**

Section 104 (A.C.A. § 4-43-104) first appeared in the 1976 Act. It requires that a limited partnership have certain minimum contacts with its State of organiza-

tion, i.e., an office at which the constitutive documents and basic financial information is kept and an agent for service of process.

**Comment to Section 105 (A.C.A. § 4-43-105)**

Section 105 (A.C.A. § 4-43-105) first appeared in the 1976 Act. In view of the passive nature of the limited partner's position, it has been widely felt that limited partners are entitled to access to certain basic documents and information, including the certificate of limited partnership, any partnership agreement, and a writing setting out certain important matters which, under the 1916 and 1976 Acts, were required to be set out in the

certificate of limited partnership. In view of the great diversity among limited partnerships, it was thought inappropriate to require a standard form of financial report, and Section 105 (A.C.A. § 4-43-105) does no more than require retention of tax returns and any other financial statements that are prepared. The names and addresses of the general partners are made available to the general public in the certificate of limited partnership.

**Comment to Section 106 (A.C.A. § 4-43-106)**

Section 106 (A.C.A. § 4-43-106) is identical to Section 3 of the 1916 Act. Many states require that certain regulated industries, such as banking, may be carried on only by entities organized pursuant to

special statutes, and it is contemplated that the prohibited activities would be confined to the matters covered by those statutes.

**Comment to Section 107 (A.C.A. § 4-43-107)**

Section 107 (A.C.A. § 4-43-107) makes a number of important changes in Section 13 of the 1916 Act. Section 13, in effect, created a special fraudulent conveyance provision applicable to the making of secured loans by limited partners and the repayment by limited partnerships of loans from limited partners. Section 107 (A.C.A. § 4-43-107) leaves that question to a state's general fraudulent conveyance

statute. In addition, Section 107 (A.C.A. § 4-43-107) eliminates the prohibition in Section 13 against a general partner's sharing pro rata with general creditors in the case of an unsecured loan. Of course, other doctrines developed under bankruptcy and insolvency laws may require the subordination of loans by partners under appropriate circumstances.

**Comment to Section 201 (A.C.A. § 4-43-201)**

The 1985 Act requires far fewer matters to be set forth in the certificate of limited partnership than did Section 2 of the 1916 Act and Section 201 of the 1976 Act. This is in recognition of the fact that the partnership agreement, not the certificate of limited partnership, has become the authoritative and comprehensive document for most limited partnerships, and that creditors and potential creditors of the partnership do and should refer to the partnership agreement and to other information furnished to them directly by the

partnership and by others, not to the certificate of limited partnership, to obtain facts concerning the capital and finances of the partnership and other matters of concern. Subparagraph (b) (A.C.A. § 4-43-201(b)), which is based upon the 1916 Act, has been retained to make it clear that the existence of the limited partnership depends only upon compliance with this section. Its continued existence is not dependent upon compliance with other provisions of this Act.



**Comment to Section 202 (A.C.A. § 4-43-202)**

Section 202 of the 1976 Act made substantial changes in Section 24 of the 1916 Act. Further changes in this section are made by the 1985 Act. Paragraph (b) (A.C.A. § 4-43-202(b)) lists the basic events—the addition or withdrawal of a general partner—that are so central to the function of the certificate of limited partnership that they require prompt amendment. With the elimination of the requirement that the certificate of limited partnership include the names of all limited partners and the amount and character of all capital contributions, the requirement of the 1916 and 1976 Acts that the certificate be amended upon the admission or withdrawal of limited partners or on any change in the partnership capital must also be eliminated. This change should greatly reduce the frequency and complexity of amendments to the certificate of limited partnership. Paragraph (c) (A.C.A. § 4-43-202(c)) makes it clear, as it was not clear under Section 24(2)(g) of the 1916 Act, that the certificate of limited partnership is intended to be an accurate description of the facts to which it relates at all times and does not speak merely as of the date it is executed.

Paragraph (e) (A.C.A. § 4-43-202(e)) provides a “safe harbor” against claims of creditors or others who assert that they have been misled by the failure to amend the certificate of limited partnership to reflect changes in any of the important facts referred to in paragraph (b) (A.C.A. § 4-43-202(b)); if the certificate of limited partnership is amended within 30 days of the occurrence of the event, no creditor or other person can recover for damages sustained during the interim. Additional pro-

tection is afforded by the provisions of Section 304 (A.C.A. § 4-43-304). The elimination of the requirement that the certificate of limited partnership identify all limited partners and their respective capital contributions may have rendered paragraph (e) (A.C.A. § 4-43-202(e)) an obsolete and unnecessary vestige. The principal, if not the sole, purpose of paragraph (e) in the 1976 Act was to protect limited partners newly admitted to a partnership from being held liable as general partners when an amendment to the certificate identifying them as limited partners and describing their contributions was not filed contemporaneously with their admission to the partnership. Such liability cannot arise under the 1985 Act because such information is not required to be stated in the certificate. Nevertheless, the 1985 Act retains paragraph (e) (A.C.A. § 4-43-202(e)) because it is protective of partners, shielding them from liability to the extent its provisions apply, and does not create or impose any liability.

Paragraph (f) (A.C.A. § 4-43-202(f)) is added in the 1985 Act to provide explicit statutory recognition of the common practice of restating an amended certificate of limited partnership. While a limited partnership seeking to amend its certificate of limited partnership may do so by recording a restated certificate which incorporates the amendment, that is by no means the only purpose or function of a restated certificate, which may be filed for the sole purpose of restating in a single integrated instrument all the provisions of a limited partnership's certificate of limited partnership which are then in effect.

**Comment to Section 203 (A.C.A. § 4-43-203)**

Section 203 (A.C.A. § 4-43-203) changes Section 24 of the 1916 Act by making it clear that the certificate of cancellation should be filed upon the com-

mencement of winding up of the limited partnership. Section 24 provided for cancellation “when the partnership is dissolved.”

**Comment to Section 204 (A.C.A. § 4-43-204)**

Section 204 (A.C.A. § 4-43-204) collects in one place the formal requirements for the execution of certificates which were set forth in Sections 2 and 25 of the 1916 Act. Those sections required that each certificate be signed by all partners, and there developed an unnecessarily cumbersome practice of having each limited partner sign powers of attorney to authorize the general partners to execute certificates of amendment on their behalf. The 1976 Act, while simplifying the execution requirements, nevertheless required that an original certificate of limited partnership be signed by all partners and a certificate of amendment by all new partners being admitted to the limited partnership. However, the certificate of limited partnership is no longer required to include the name or capital contribution of any

limited partner. Therefore, while the 1985 Act still requires all general partners to sign the original certificate of limited partnership, no limited partner is required to sign any certificate. Certificates of amendment are required to be signed by only one general partner and all general partners must sign certificates of cancellation. The requirement in the 1916 Act that all certificates be sworn was deleted in the 1976 and 1985 Acts as potentially an unfair trap for the unwary (see, e.g., *Wisniewski v. Johnson*, 223 Va. 141, 286 S.E.2d 223 (1982)); in its place, paragraph (c) (A.C.A. § 4-43-204(c)) now provides, as a matter of law, that the execution of a certificate by a general partner subjects him to the penalties of perjury for inaccuracies in the certificate.

**Comment to Section 205 (A.C.A. § 4-43-205)**

Section 205 of the 1976 Act changed subdivisions (3) and (4) of Section 25 of the 1916 Act by confining the persons who have standing to seek judicial intervention to partners and to those assignees who were adversely affected by the failure or refusal of the appropriate persons to file a certificate of amendment or cancella-

tion. Section 205 (A.C.A. § 4-43-205) of the 1985 Act reverses that restriction, and provides that any person adversely affected by a failure or refusal to file any certificate (not only a certificate of cancellation or amendment) has standing to seek judicial intervention.

**Comment to Section 206 (A.C.A. § 4-43-206)**

Section 206 (A.C.A. § 4-43-206) first appeared in the 1976 Act. In addition to providing mechanics for the central filing system, the second sentence of this section does away with the requirement, formerly imposed by some local filing officers, that persons who have executed certificates under a power of attorney exhibit exe-

cuted copies of the power of attorney itself. Paragraph (b) (A.C.A. § 4-43-206(b)) changes subdivision (5) of Section 25 of the 1916 Act by providing that certificates of cancellation are effective upon their effective date under Section 203 (A.C.A. § 4-43-203).

**Comment to Section 207 (A.C.A. § 4-43-207)**

Section 207 (A.C.A. § 4-43-207) changes Section 6 of the 1916 Act by providing explicitly for the liability of persons who sign a certificate as agent under

a power of attorney and by confining the obligation to amend a certificate of limited partnership in light of future events to general partners.



**Comment to Section 208 (A.C.A. § 4-43-208)**

Section 208 (A.C.A. § 4-43-208) first appeared in the 1976 Act, and referred to the certificate's providing constructive notice of the status as limited partners of those so identified therein. The 1985 Act's deletion of any requirement that the certificate name limited partners required that Section 208 (A.C.A. § 4-43-208) be modified accordingly.

By stating that the filing of a certificate of limited partnership only results in notice of the general liability of the general

partners, Section 208 (A.C.A. § 4-43-208) obviates the concern that third parties may be held to have notice of special provisions set forth in the certificate. While this section (A.C.A. § 4-43-208) is designed to preserve by implication the limited liability of limited partners, the implicit protection provided is not intended to change any liability of a limited partner which may be created by his action or inaction under the law of estoppel, agency, fraud, or the like.

**Comment to Section 209 (A.C.A. § 4-43-209)**

This section (A.C.A. § 4-43-209) first appeared in the 1976 Act.

**Comment to Section 301 (A.C.A. § 4-43-301)**

Section 301(a) (A.C.A. § 4-43-301(a)) is new; no counterpart was found in the 1916 or 1976 Acts. This section (A.C.A. § 4-43-301) imposes on the partnership an obligation to maintain in its records the date each limited partner becomes a limited partner. Under the 1976 Act, one could not become a limited partner until an appropriate certificate reflecting his status as such was filed with the Secretary of State. Because the 1985 Act eliminates the need to name limited partners in the certificate of limited partnership, an alternative mechanism had to be established to evidence the fact and date of a limited partner's admission. The partnership records required to be maintained

under Section 105 (A.C.A. § 4-43-105) now serve that function, subject to the limitation that no person may become a limited partner before the partnership is formed (Section 201(b)) (A.C.A. § 4-43-201(b)).

Subdivision (1) of Section 301(b) (A.C.A. § 4-43-301(b)(1)) adds to Section 8 of the 1916 Act an explicit recognition of the fact that unanimous consent of all partners is required for admission of new limited partners unless the partnership agreement provides otherwise. Subdivision (2) (A.C.A. § 4-43-301(b)(2)) is derived from Section 19 of the 1916 Act but abandons the former terminology of "substituted limited partner."

**Comment to Section 302 (A.C.A. § 4-43-302)**

Section 302 (A.C.A. § 4-43-302) first appeared in the 1976 Act, and must be read together with subdivision (b)(6) of Section 303 (A.C.A. § 4-43-303(b)(6)). Although the 1916 Act did not speak specifically of the voting powers of limited partners, it was not uncommon for partnership agreements to grant such powers to limited partners. Section 302 (A.C.A. § 4-43-302) is designed only to make it clear that the partnership agreement may grant such power to limited partners. If such powers are granted to

limited partners beyond the "safe harbor" of subdivision (6) or (8) of Section 303(b) (A.C.A. §§ 4-43-303(b)(6) and (8)), a court may (but of course need not) hold that, under the circumstances, the limited partners have participated in "control of the business" within the meaning of Section 303(a) (A.C.A. § 4-43-303(a)). Section 303(c) (A.C.A. § 4-43-303(c)) makes clear that the exercise of powers beyond the ambit of Section 303(b) (A.C.A. § 4-43-303(b)) is not ipso facto to be taken as taking part in the control of the business.

**Comment to Section 303 (A.C.A. § 4-43-303)**

Section 303 (A.C.A. § 4-43-303) makes several important changes in Section 7 of the 1916 Act. The first sentence of Section 303(a) (A.C.A. § 4-43-303(a)) differs from the text of Section 7 of the 1916 Act in that it speaks of participating (rather than taking part) in the control of the business; this was done for the sake of consistency with the second sentence of Section 303(a) (A.C.A. § 4-43-303(a)), not to change the meaning of the text. It is intended that judicial decisions interpreting the phrase "takes part in the control of the business" under the prior uniform law will remain applicable to the extent that a different result is not called for by other provisions of Section 303 (A.C.A. § 4-43-303) and other provisions of the Act. The second sentence of Section 303(a) (A.C.A. § 4-43-303(a)) reflects a wholly new concept in the 1976 Act that has been further modified in the 1985 Act. It was adopted partly because of the difficulty of determining when the "control" line has been overstepped, but also (and more importantly) because of a determination that it is not

sound public policy to hold a limited partner who is not also a general partner liable for the obligations of the partnership except to persons who have done business with the limited partnership reasonably believing, based on the limited partner's conduct, that he is a general partner. Paragraph (b) (A.C.A. § 4-43-303(b)) is intended to provide a "safe harbor" by enumerating certain activities which a limited partner may carry on for the partnership without being deemed to have taken part in control of the business. This "safe harbor" list has been expanded beyond that set out in the 1976 Act to reflect case law and statutory developments and more clearly to assure that limited partners are not subjected to general liability where such liability is inappropriate. Paragraph (d) (A.C.A. § 4-43-303(d)) is derived from Section 5 of the 1916 Act, but adds as a condition to the limited partner's liability the requirement that a limited partner must have knowingly permitted his name to be used in the name of the limited partnership.

**Comment to Section 304 (A.C.A. § 4-43-304)**

Section 304 (A.C.A. § 4-43-304) is derived from Section 11 of the 1916 Act. The "good faith" requirement has been added in the first sentence of Section 304(a) (A.C.A. § 4-43-304(a)). The provisions of subdivision (2) of Section 304(a) (A.C.A. § 4-43-304(a)(2)) are intended to clarify an ambiguity in the prior law by providing that a person who chooses to withdraw from the enterprise in order to protect himself from liability is not required to renounce any of his then current interest in the enterprise so long as he has no further participation as an equity participant. Paragraph (b) (A.C.A. § 4-43-304(b)) preserves the liability of the equity participant prior to withdrawal by such person from the limited partnership or amendment to the certificate demonstrating that such person is not a general partner to any third party who has transacted business with the person believing

in good faith that he was a general partner.

Evidence strongly suggests that Section 11 of the 1916 Act and Section 304 of the 1976 Act were rarely used, and one might expect that Section 304 (A.C.A. § 4-43-304) of the 1985 Act may never have to be used. Section 11 of the 1916 Act and Section 304 of the 1976 Act could have been used by a person who invested in a limited partnership believing he would be a limited partner but who was not identified as a limited partner in the certificate of limited partnership. However, because the 1985 Act does not require limited partners to be named in the certificate, the only situation to which Section 304 (A.C.A. § 4-43-304) would now appear to be applicable is one in which a person intending to be a limited partner was erroneously identified as a general partner in the certificate.



**Comment to Section 305 (A.C.A. § 4-43-305)**

Section 305 (A.C.A. § 4-43-305) changes and restates the rights of limited partners to information about the partnership formerly provided by Section 10 of the 1916 Act. Its importance has increased as a result of the 1985 Act's substituting the records of the partnership for the certificate of limited partnership as the place where certain categories of information are to be kept.

Section 305 (A.C.A. § 4-43-305), which should be read together with Section 105(b) (A.C.A. § 4-43-105(b)), provides a

mechanism for limited partners to obtain information about the partnership useful to them in making decisions concerning the partnership and their investments in it. Its purpose is not to provide a mechanism for competitors of the partnership or others having interests or agendas adverse to the partnership's to subvert the partnership's business. It is assumed that courts will protect limited partnerships from abuses and attempts to misuse Section 305 (A.C.A. § 4-43-305) for improper purposes.

**Comment to Section 401 (A.C.A. § 4-43-401)**

Section 401 (A.C.A. § 4-43-401) is derived from, but represents a significant departure from, Section 9(1)(e) of the 1916 Act and Section 401 of the 1976 Act, which required, as a condition to the admission of an additional general partner, that all limited partners consent and that such consent specifically identify the general partner involved. Section 401 (A.C.A. § 4-

43-401) of the 1985 Act provides that the written partnership agreement determines the procedure for authorizing the admission of additional general partners, and that the written consent of all partners is required only when the partnership agreement fails to address the question.

**Comment to Section 402 (A.C.A. § 4-43-402)**

Section 402 (A.C.A. § 4-43-402) expands considerably the provisions of Section 20 of the 1916 Act, which provided for dissolution in the event of the retirement, death or insanity of a general partner. Subdivisions (1), (2) and (3) (A.C.A. § 4-43-402(1), (2), and (3)) recognize that the general partner's agency relationship is terminable at will, although it may result in a breach of the partnership agreement giving rise to an action for damages. Subdivisions (4) and (5) (A.C.A. § 4-43-402(4) and (5)) reflect a judgment that, unless the limited partners agree otherwise, they ought to have the power to rid themselves of a general partner who is in such dire financial straits that he is the subject of proceedings under the National Bankruptcy Code or a similar provision of law. Subdivisions (6) through (10) (A.C.A. § 4-

43-402(6) — (10)) simply elaborate on the notion of death in the case of a general partner who is not a natural person. Subdivisions (4) and (5) (A.C.A. § 4-43-402(4) and (5)) differ from their counterparts in the 1976 Act, reflecting the policy underlying the 1985 revision of Section 201 (A.C.A. § 4-43-201), that the partnership agreement, not the certificate of limited partnership, is the appropriate document for setting out most provisions relating to the respective powers, rights and obligations of the partners inter se. Although the partnership agreement need not be written, the 1985 Act provides that, to protect the partners from fraud, these and certain other particularly significant provisions must be set out in a written partnership agreement to be effective for the purposes described in the Act.

**Comment to Section 403 (A.C.A. § 4-43-403)**

Section 403 (A.C.A. § 4-43-403) is derived from Section 9(1) of the 1916 Act.

**Comment to Section 404 (A.C.A. § 4-43-404)**

Section 404 (A.C.A. § 4-43-404) is derived from Section 12 of the 1916 Act and makes clear that the partnership agree-

ment may provide that a general partner who is also a limited partner may exercise all of the powers of a limited partner.

**Comment to Section 405 (A.C.A. § 4-43-405)**

Section 405 (A.C.A. § 4-43-405) first appeared in the 1976 Act and is intended to make it clear that the Act does not

require that the limited partners have any right to vote on matters as a separate class.

**Comment to Section 501 (A.C.A. § 4-43-501)**

As noted in the comment to Section 101 (A.C.A. § 4-43-101), the explicit permis-

sion to make contributions of services expands Section 4 of the 1916 Act.

**Comment to Section 502 (A.C.A. § 4-43-502)**

Section 502(a) (A.C.A. § 4-43-502(a)) is new; it has no counterpart in the 1916 or 1976 Act. Because, unlike the prior uniform acts, the 1985 Act does not require that promises to contribute cash, property, or services be described in the limited partnership certificate, to protect against fraud it requires instead that such important promises be in a signed writing.

Although Section 17(1) of the 1916 Act required a partner to fulfill his promise to make contributions, the addition of contri-

butions in the form of a promise to render services means that a partner who is unable to perform those services because of death or disability as well as because of an intentional default is required to pay the cash value of the services unless the partnership agreement provides otherwise.

Subdivision (c) (A.C.A. § 4-43-502(c)) is derived from, but expands upon, Section 17(3) of the 1916 Act.

**Comment to Section 503 (A.C.A. § 4-43-503)**

Section 503 (A.C.A. § 4-43-503) first appeared in the 1976 Act. The 1916 Act did not provide the basis on which partners would share profits and losses in the absence of agreement. The 1985 Act differs from its counterpart in the 1976 Act by requiring that, to be effective, the part-

nership agreement provisions concerning allocation of profits and losses be in writing, and by its reference to records required to be kept pursuant to Section 105 (A.C.A. § 4-43-105), the latter reflecting the 1986 changes in Section 201 (A.C.A. § 4-43-201).

**Comment to Section 504 (A.C.A. § 4-43-504)**

Section 504 (A.C.A. § 4-43-504) first appeared in the 1976 Act. The 1916 Act did not provide the basis on which partners would share distributions in the absence of agreement. Section 504 (A.C.A. § 4-43-504) also differs from its counterpart in the 1976 Act by requiring that, to

be effective, the partnership agreement provisions concerning allocation of distributions be in writing, and in its reference to records required to be kept pursuant to Section 105 (A.C.A. § 4-43-105), the latter reflecting the 1985 changes in Section 201 (A.C.A. § 4-43-201). This section also rec-



ognizes that partners may choose to share in distributions on a basis different from that on which they share in profits and losses.

#### **Comment to Section 601 (A.C.A. § 4-43-601)**

Section 601 (A.C.A. § 4-43-601) first appeared in the 1976 Act. The 1976 Act provisions have been modified to reflect the 1985 changes made in Section 201 (A.C.A. § 4-43-201).

#### **Comment to Section 602 (A.C.A. § 4-43-602)**

Section 602 (A.C.A. § 4-43-602) first appeared in the 1976 Act, but is generally derived from Section 38 of the Uniform Partnership Act.

#### **Comment to Section 603 (A.C.A. § 4-43-603)**

Section 603 (A.C.A. § 4-43-603) is derived from Section 16 of the 1916 Act. The 1976 Act provision has been modified to reflect the 1985 changes made in Section 201 (A.C.A. § 4-43-201). This section additionally reflects the policy determination, also embodied in certain other sections of the 1985 Act, that to avoid fraud, agreements concerning certain matters of substantial importance to the partners will be enforceable only if in writing. If the partnership agreement does provide, in writing, whether a limited partner may withdraw and, if he may, when and on what terms and conditions, those provisions will control.

#### **Comment to Section 604 (A.C.A. § 4-43-604)**

Section 604 (A.C.A. § 4-43-604) first appeared in the 1976 Act. It fixes the distributive share of a withdrawing partner in the absence of an agreement among the partners.

#### **Comment to Section 605 (A.C.A. § 4-43-605)**

The first sentence of Section 605 (A.C.A. § 4-43-605) is derived from Section 16(3) of the 1916 Act; it also differs from its counterpart in the 1976 Act, reflecting the 1985 changes made in Section 201 (A.C.A. § 4-43-201). The second sentence first appeared in the 1976 Act, and is intended to protect a limited partner (and the remaining partners) against a distribution in kind of more than his share of particular assets.

#### **Comment to Section 606 (A.C.A. § 4-43-606)**

Section 606 (A.C.A. § 4-43-606) first appeared in the 1976 Act, and is intended to make it clear that the right of a partner to receive a distribution, as between the partners, is not subject to the equity risks of the enterprise. On the other hand, since partners entitled to distributions have creditor status, there did not seem to be a need for the extraordinary remedy of Section 16(4)(a) of the 1916 Act, which granted a limited partner the right to seek dissolution of the partnership if he was unsuccessful in demanding the return of his contribution. It is more appropriate for the partner to simply sue as an ordinary creditor and obtain a judgment.

**Comment to Section 607 (A.C.A. § 4-43-607)**

Section 607 (A.C.A. § 4-43-607) is derived from Section 16(1)(a) of the 1916 Act.

**Comment to Section 608 (A.C.A. § 4-43-608)**

Paragraph (a) (A.C.A. § 4-43-608(a)) is derived from Section 17(4) of the 1916 Act, but the one year statute of limitations has been added. Paragraph (b) (A.C.A. § 4-43-608(b)) is derived from Section 17(2)(b) of the 1916 Act but, again, a statute of limitations has been added.

Paragraph (c) (A.C.A. § 4-43-608(c)) first appeared in the 1976 Act. The provi-

sions of former Section 17(2) that referred to the partner holding as "trustee" any money or specific property wrongfully returned to him have been eliminated. Paragraph (c) (A.C.A. § 4-43-608(c)) in the 1985 Act also differs from its counterpart in the 1976 Act to reflect the 1985 changes made in Sections 105 and 201 (A.C.A. §§ 4-43-105 and 4-43-201).

**Comment to Section 701 (A.C.A. § 4-43-701)**

This section is derived from Section 18 of the 1916 Act.

**Comment to Section 702 (A.C.A. § 4-43-702)**

Section 19(1) of the 1916 Act provided simply that "a limited partner's interest is assignable", raising a question whether any limitations on the right of assignment were permitted. While the first sentence of Section 702 (A.C.A. § 4-43-702) recognizes that the power to assign may be restricted in the partnership agreement,

there was no intention to affect in any way the usual rules regarding restraints on alienation of personal property. The second and third sentences of Section 702 (A.C.A. § 4-43-702) are derived from Section 19(3) of the 1916 Act. The last sentence first appeared in the 1976 Act.

**Comment to Section 703 (A.C.A. § 4-43-703)**

Section 703 (A.C.A. § 4-43-703) is derived from Section 22 of the 1916 Act but has not carried over some provisions that were thought to be superfluous. For example, references in Section 22(1) to specific remedies have been omitted, as has a

prohibition in Section 22(2) against discharge of the lien with partnership property. Ordinary rules governing the remedies available to a creditor and the fiduciary obligations of general partners will determine those matters.

**Comment to Section 704 (A.C.A. § 4-43-704)**

Section 704 (A.C.A. § 4-43-704) is derived from Section 19 of the 1916 Act, but paragraph (b) (A.C.A. § 4-43-704(b)) defines more narrowly than Section 19 the obligations of the assignor that are auto-

matically assumed by the assignee. Section 704 (A.C.A. § 4-43-704) of the 1985 Act also differs from the 1976 Act to reflect the 1985 changes made in Section 201 (A.C.A. § 4-43-201).



**Comment to Section 705 (A.C.A. § 4-43-705)**

Section 705 (A.C.A. § 4-43-705) is derived from Section 21(1) of the 1916 Act. Former Section 21(2), making a deceased limited partner's estate liable for his lia-

bilities as a limited partner was deleted as superfluous, with no intention of changing the liability of the estate.

**Comment to Section 801 (A.C.A. § 4-43-801)**

Section 801 (A.C.A. § 4-43-801) merely collects in one place all of the events causing dissolution. Paragraph (3)\* is derived from Sections 9(1)(g) and 20 of the 1916 Act, but adds the 90-day grace period. Section 801 (A.C.A. § 4-43-801) also differs from its counterpart in the 1976 Act to reflect the 1985 changes made in Section 201 (A.C.A. § 4-43-201).

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\*This reference does not reflect the changes in the 1985 Act which redesignated Section 801(3) of the 1976 Act as Section 801(4) (A.C.A. § 4-43-801(4)).

**Comment to Section 802 (A.C.A. § 4-43-802)**

Section 802 (A.C.A. § 4-43-802) first appeared in the 1976 Act.

**Comment to Section 803 (A.C.A. § 4-43-803)**

Section 803 (A.C.A. § 4-43-803) first appeared in the 1976 Act, and is derived

in part from Section 37 of the Uniform Partnership Act.

**Comment to Section 804 (A.C.A. § 4-43-804)**

Section 804 (A.C.A. § 4-43-804) revises Section 23 of the 1916 Act by providing that (1) to the extent partners are also creditors, other than in respect of their interests in the partnership, they share with other creditors, (2) once the partnership's obligation to make a distribution

accrues, it must be paid before any other distributions of an "equity" nature are made, and (3) general and limited partners rank on the same level except as otherwise provided in the partnership agreement.

**Comment to Section 901 (A.C.A. § 4-43-901)**

Section 901 (A.C.A. § 4-43-901) first appeared in the 1976 Act.

**Comment to Section 902 (A.C.A. § 4-43-902)**

Section 902 (A.C.A. § 4-43-902) first appeared in the 1976 Act. It was thought that requiring a full copy of the certificate of limited partnership and all amendments thereto to be filed in each state in which the partnership does business would impose an unreasonable burden on interstate limited partnerships and that the information Section 902 (A.C.A. § 4-43-902) required to be filed would be suf-

ficient to tell interested persons where they could write to obtain copies of those basic documents. Subdivision (3) of the 1976 Act has been omitted, and subdivisions (6) and (7) (A.C.A. § 4-43-902(6) and (7)) differ from their counterparts in the 1976 Act, to conform these provisions relating to the registration of foreign limited partnerships to the corresponding changes made by the Act in the provisions

relating to domestic limited partnerships. The requirement that an application for registration be sworn to by a general partner is simply intended to produce the same result as is provided for in Section 204(c) (A.C.A. § 4-43-204(c)) with respect to certificates of domestic limited partnerships; the acceptance and endorsement by the Secretary of State (or equivalent au-

thority) of an application which was not sworn by a general partner should be deemed a mere technical and insubstantial shortcoming, and should not result in the limited partners' being subjected to general liability for the obligations of the foreign limited partnership (See Section 907(c)) (A.C.A. § 4-43-907(c)).

#### **Comment to Section 903 (A.C.A. § 4-43-903)**

Section 903 (A.C.A. § 4-43-903) first appeared in the 1976 Act.

#### **Comment to Section 904 (A.C.A. § 4-43-904)**

Section 904 (A.C.A. § 4-43-904) first appeared in the 1976 Act.

#### **Comment to Section 905 (A.C.A. § 4-43-905)**

Section 905 (A.C.A. § 4-43-905) first appeared in the 1976 Act. It corresponds to the provisions of Section 202(c) (A.C.A. § 4-43-202(c)) relating to domestic limited partnerships.

#### **Comment to Section 906 (A.C.A. § 4-43-906)**

Section 906 (A.C.A. § 4-43-906) first appeared in the 1976 Act.

#### **Comment to Section 907 (A.C.A. § 4-43-907)**

Section 907 (A.C.A. § 4-43-907) first appeared in the 1976 Act.

#### **Comment to Section 908 (A.C.A. § 4-43-908)**

Section 908 (A.C.A. § 4-43-908) first appeared in the 1976 Act.

#### **Comment to Section 1001 (A.C.A. § 4-43-1001)**

Section 1001 (A.C.A. § 4-43-1001) first appeared in the 1976 Act.

#### **Comment to Section 1002 (A.C.A. § 4-43-1002)**

Section 1002 (A.C.A. § 4-43-1002) first appeared in the 1976 Act.



**Comment to Section 1003 (A.C.A. § 4-43-1003)**

Section 1003 (A.C.A. § 4-43-1003) first appeared in the 1976 Act.

**Comment to Section 1004 (A.C.A. § 4-43-1004)**

Section 1004 (A.C.A. § 4-43-1004) first appeared in the 1976 Act.

**Comment to Section 1101 (A.C.A. § 4-43-1101)**

Because the principles set out in Sections 28(1) and 29 of the 1916 Act have become so universally established, it was felt that the 1976 and 1985 Acts need not

contain express provisions to the same effect. However, it is intended that the principles enunciated in those provisions of the 1916 Act also apply to this Act.

**Comment to Section 1104 (A.C.A. § 4-43-1104)\***

Subdivisions (6) and (7) did not appear in Section 1104 of the 1976 Act. They are included in the 1985 Act to ensure that the application of the Act to limited partnerships formed and existing before the Act becomes effective would not violate constitutional prohibitions against the impairment of contracts.

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\*The version adopted by the Arkansas General Assembly varies from this uniform act.

**Comment to Section 1105 (A.C.A. § 4-43-1105)**

The result provided for in Section 1105 (A.C.A. § 4-43-1107) would obtain even in its absence in a jurisdiction which had

adopted the Uniform Partnership Act, by operation of Section 6 of that act.

**Comment to Section 1106 (A.C.A. § 4-43-1106)\***

Section 1106 did not appear in the 1976 Act. It was included in the 1985 Act to ensure that the application of the Act to limited partnerships formed and existing before the Act becomes effective would not violate constitutional prohibitions against the impairment of contracts.

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\*The version adopted by the Arkansas General Assembly varies from this uniform act.

## UNIFORM FRAUDULENT TRANSFER ACT (§ 4-59-201 ET SEQ.)

### Prefatory Note

The Uniform Fraudulent Conveyance Act was promulgated by the Conference of Commissioners on Uniform State Laws in 1918. The Act has been adopted in 25 jurisdictions, including the Virgin Islands. It has also been adopted in the sections of the Bankruptcy Act of 1938 and the Bankruptcy Reform Act of 1978 that deal with fraudulent transfers and obligations.

The Uniform Act was a codification of the "better" decisions applying the Statute of 13 Elizabeth. See Analysis of H.R. 12339, 74th Cong., 2d Sess. 213 (1936). The English statute was enacted in some form in many states, but, whether or not so enacted, the voidability of fraudulent transfer was part of the law of every American jurisdiction. Since the intent to hinder, delay, or defraud creditors is seldom susceptible of direct proof, courts have relied on badges of fraud. The weight given these badges varied greatly from jurisdiction, and the Conference sought to minimize or eliminate the diversity by providing that proof of certain fact combinations would conclusively establish fraud. In the absence of evidence of the existence of such facts, proof of a fraudulent transfer was to depend on the evidence of actual intent. An important reform effected by the Uniform Act was the elimination of any requirement that a creditor have obtained a judgment or execution returned unsatisfied before bringing an action to avoid a transfer as fraudulent. See *American Surety Co. v. Conner*, 251 N.Y. 1, 166 N.E. 783, 67 A.L.R. 244 (1929) (per C.J. Cardozo).

The Conference was persuaded in 1979 to appoint a committee to undertake a study of the Uniform Act with a view to preparing the draft of a revision. The Conference was influenced by the following considerations:

(1) The Bankruptcy Reform Act of 1978 has made numerous changes in the section of that Act dealing with fraudulent transfers and obligations, thereby substantially reducing the correspondence of the provisions of the federal bankruptcy

law on fraudulent transfers with the Uniform Act.

(2) The Committee on Corporate Laws of the Section of Corporations, Banking & Business Law of the American Bar Association, engaged in revising the Model Corporation Act, suggested that the Conference review provisions of the Uniform Act with a view to determining whether the Acts are consistent in respect to the treatment of dividend distributions.

(3) The Uniform Commercial Code, enacted at least in part by all 50 states, had substantially modified related rules of law regulating transfers of personal property, notable by facilitating the making and perfection of security transfers against attack by unsecured creditors.

(4) Debtors and trustees in a number of cases have avoided foreclosure of security interests by invoking the fraudulent transfer section of the Bankruptcy Reform Act.

(5) The Model Rules of Professional Conduct adopted by the House of Delegates of the American Bar Association on August 2, 1983, forbid a lawyer to counsel or to assist a client in conduct that the lawyer knows is fraudulent.

The Drafting Committee appointed by the Conference held its first meeting in January of 1983. A first reading of a draft of the revision of the Uniform Fraudulent Conveyance Act was had at the Conference's meeting in Boca Raton, Florida, on July 27, 1983. The Committee held four meetings in addition to a meeting held in connection with the Conference meeting in Boca Raton. Meetings were also attended by the following representatives of interested organizations:

Robert Rosenberg, Esq., of the American Bar Association;

Richard Cherin, Esq., of the Commercial Financial Services Committee of the Corporation, Banking and Business Law Section of the American Bar Association;

Robert Zinman, Esq., of the American College of Real Estate Lawyers;

Bruce Bernstein, Esq., of the National Commercial Finance Association;



Ernest E. Specks, Esq., of the Real Property, Probate and Trust Law Section of the American Bar Association.

The Committee determined to rename the Act the Uniform Fraudulent Transfer Act in recognition of its applicability to transfers of personal property as well as real property, "conveyance" having a connotation restricting it to a transfer of personal property. As noted in Comment (2) accompanying § 1(2) (A.C.A. § 4-59-201 (2)) and Comment 8 accompanying § 4 (A.C.A. § 4-59-204), however, this Act, like the original Uniform Act, does not purport to cover the whole law of voidable transfers and obligations. The limited scope of the original Act did not impair its effectiveness in achieving uniformity in the areas covered. See McLaughlin, *Application of the Uniform Fraudulent Conveyance Act*, 46 Harv.L.Rev. 404, 405 (1933).

The basic structure and approach of the Uniform Fraudulent Conveyance Act are preserved in the Uniform Fraudulent Transfer Act. There are two sections in the new Act delineating what transfers and obligations are fraudulent. Section 4(a) (A.C.A. § 4-59-204(a)) is an adaptation of three sections of the U.F.C.A.; § 5(a) (A.C.A. § 4-59-205(a)) is an adaptation of another section of the U.F.C.A.; and § 5(b) (A.C.A. § 4-59-205(b)) is new. One section of the U.F.C.A. (§ 8) is not carried forward into the new Act because deemed to be redundant in part and in part susceptible of inequitable application. Both Acts declare a transfer made or an obligation incurred with actual intent to hinder, delay, or defraud creditors to be fraudulent. Both Acts render a transfer made or obligation incurred without adequate consideration to be constructively fraudulent — i.e., without regard to the actual intent of the parties — under one of the following conditions:

(1) the debtor was left by the transfer or obligation with unreasonably small assets for a transaction or the business in which he was engaged;

(2) the debtor intended to incur, or believed that he would incur, more debts than he would be able to pay; or

(3) the debtor was insolvent at the time or as a result of the transfer or obligation. As under the original Uniform Fraudulent Conveyance Act a transfer or obligation that is constructively fraudulent because

insolvency concurs with or follows failure to receive adequate consideration is voidable only by a creditor in existence at the time the transfer occurs or the obligation is incurred. Either an existing or subsequent creditor may avoid a transfer or obligation for inadequate consideration when accompanied by the financial condition specified in § 4(a)(2)(i) (A.C.A. § 4-59-204(a)(2)(i)) or the mental state specified in § 4(a)(2)(ii) (A.C.A. § 4-59-204(a)(2)(ii)).

Reasonably equivalent value is required in order to constitute adequate consideration under the revised Act. The revision follows the Bankruptcy Code in eliminating good faith on the part of the transferee or obligee as an issue in the determination of whether adequate consideration is given by a transferee or obligee. The new Act, like the Bankruptcy Act, allows the transferee or the obligee to show good faith in defense after a creditor establishes that a fraudulent transfer has been made or a fraudulent obligation has been incurred. Thus a showing by a defendant that a reasonable equivalent has been given in good faith for a transfer or obligation is a complete defense although the debtor is shown to have intended to hinder, delay, or defraud creditors.

A good faith transferee or obligee who has given less than a reasonable equivalent is nevertheless allowed a reduction in a liability to the extent of the value given. The new Act, like the Bankruptcy Code, eliminates the provision of the Uniform Fraudulent Conveyance Act that enables a creditor to attack a security transfer on the ground that the value of the property transferred is disproportionate to the debt secured. The premise of the new Act is that the value of the interest transferred for security is measured by and thus corresponds exactly to the debt secured. Foreclosure of a debtor's interest by a regularly conducted, noncollusive sale on default under a mortgage or other security agreement may not be avoided under the Act as a transfer for less than a reasonably equivalent value.

The definition of insolvency under the Act is adapted from the definition of the term in the Bankruptcy Code. Insolvency is presumed from proof of a failure generally to pay debts as they become due.

The new Act adds a new category of fraudulent transfer, namely, a preferen-

tial transfer by an insolvent insider to a creditor who had reasonable cause to believe the debtor to be insolvent. An insider is defined in much the same way as in the Bankruptcy Code and includes a relative, also defined as in the Bankruptcy Code, a director or officer of a corporate debtor, a partner, or a person in control of a debtor. This provision is available only to an existing creditor. Its premise is that an insolvent debtor is obliged to pay debts to creditors not related to him before paying those who are insiders.

The new Act omits any provision directed particularly at transfers or obligations of insolvent partnership debtors. Under § 8 of the Uniform Fraudulent Conveyance Act any transfer made or obligation incurred by an insolvent partnership to a partner is fraudulent without regard to intent or adequacy of consideration. So categorical a condemnation of a partnership transaction with a partner may unfairly prejudice the interests of a partner's separate creditors. The new Act also omits as redundant a provision in the original Act that makes fraudulent a transfer made or obligation incurred by an insolvent partnership for less than a fair consideration to the partnership.

Section 7 (A.C.A. § 4-59-207) lists the remedies available to creditors under the new Act. It eliminates as unnecessary and confusing a differentiation made in the original Act between the remedies available to holders of matured claims and those holding unmatured claims. Since promulgation of the Uniform Fraudulent Conveyance Act the Supreme Court has imposed restrictions on the availability and use of prejudgment remedies. As a result many states have amended their statutes and rules applicable to such remedies, and it is frequently unclear whether a state's procedures include a prejudgment remedy against a fraudulent transfer or obligation. A bracketed paragraph is included in Section 7 (A.C.A. § 4-59-207) for adoption by those states that elect to make such a remedy available.\*

Section 8 (A.C.A. § 4-59-208) prescribes the measure of liability of a transferee or obligee under the Act and enumerates defenses. Defenses against avoidance of a preferential transfer to an insider under § 5(b) (A.C.A. § 4-59-205(b)) include an adaptation of defenses available under § 547(c)(2) and (4) of the Bankruptcy Code when such a transfer is sought to be avoided as a preference by the trustee in bankruptcy. In addition a preferential transfer may be justified when shown to be made pursuant to a good faith effort to stave off forced liquidation and rehabilitate the debtor. Section 8 (A.C.A. § 4-59-208) also precludes avoidance, as a constructively fraudulent transfer, of the termination of a lease on default or the enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code.

The new Act includes a new section specifying when a transfer is made or an obligation is incurred. The section specifying the time when a transfer occurs is adapted from Section 548(d) of the Bankruptcy Code. Its premise is that if the law prescribes a mode for making the transfer a matter of public record or notice, it is not deemed to be made for any purpose under the Act until it has become such a matter of record or notice.

The new Act also includes a statute of limitations that bars the right rather than the remedy on expiration of the statutory periods prescribed. The law governing limitations on actions to avoid fraudulent transfers among the states is unclear and full of diversity. The Act recognizes that laches and estoppel may operate to preclude a particular creditor from pursuing a remedy against a fraudulent transfer or obligation even though the statutory period of limitations has not run.

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\* This paragraph was adopted by Arkansas as A.C.A. § 4-59-207(a)(2).



**Comment to Section 1 (A.C.A. § 4-59-201)**

(1) The definition of "affiliate" is derived from § 101(2) of the Bankruptcy Code.

(2) The definition of "asset" is substantially to the same effect as the definition of "assets" in § 1 of the Uniform Fraudulent Conveyance Act. The definition in this Act, unlike that in the earlier Act, does not, however, require a determination that the property is liable for the debts of the debtor. Thus, an unliquidated claim for damages resulting from personal injury or a contingent claim of a surety for reimbursement, contribution, or subrogation may be counted as an asset for the purpose of determining whether the holder of the claim is solvent as a debtor under § 2 (A.C.A. § 4-59-202) of this Act, although applicable law may not allow such an asset to be levied on and sold by a creditor. Cf. *Manufacturers and Traders Trust Co. v. Goldman* (In re Ollag Construction Equipment Corp.), 578 F.2d 904, 907-09 (2d Cir. 1978).

Subparagraphs (i) (A.C.A. § 4-59-201(2)(i)), (ii) (A.C.A. § 4-59-201(2)(ii)) and (iii) (A.C.A. § 4-59-201(2)(iii)) provide clarification by excluding from the term not only generally exempt property but also an interest in a tenancy by the entirety in many states and an interest that is generally beyond reach by unsecured creditors because subject to a valid lien. This Act, like its predecessor and the Statute of 13 Elizabeth, declares rights and provides remedies for unsecured creditors against transfers that impede them in the collection of their claims. The laws protecting valid liens against impairment by levying creditors, exemption statutes, and the rules restricting levyability of interest in entireties property are limitations on the rights and remedies of unsecured creditors, and it is therefore appropriate to exclude property interests that are beyond the reach of unsecured creditors from the definition of "asset" for the purposes of this Act.

A creditor of a joint tenant or tenant in common may ordinarily collect a judgment by process against the tenant's interest, and in some states a creditor of a tenant by the entirety may likewise collect a judgment by process against the tenant's interest. See 2 American Law of

Property 10, 22, 28-32 (1952); Craig, *An Analysis of Estates by the Entirety in Bankruptcy*, 48 Am.Bankr.L.J. 255, 258-59 (1974). The levyable interest of such a tenant is included as an asset under this Act.

The definition of "assets" in the Uniform Fraudulent Conveyance Act excluded property that is exempt from liability for debts. The definition did not, however, exclude all property that cannot be reached by a creditor through judicial proceedings to collect a debt. Thus, it included the interest of a tenant by the entirety although in nearly half the states such an interest can not be subjected to liability for a debt unless it is an obligation owned jointly by the debtor with his or her cotenant by the entirety. See 2 American Law of Property 29 (1952); Craig, *An Analysis of Estates by the Entirety in Bankruptcy*, 48 Am.Bankr.L.J. 255, 258 (1974). The definition in this Act requires exclusion of interests in property held by tenants by the entirety that are not subject to collection process by a creditor without a right to proceed against both tenants by the entirety as joint debtors.

The reference to "generally exempt" property in § 1(2)(ii) (A.C.A. § 4-59-201(2)(ii)) recognizes that all exemptions are subject to exceptions. Creditors having special rights against generally exempt property typically include claimants for alimony, taxes, wages, the purchase price of the property, and labor or materials that improve the property. See Uniform Exemptions Act § 10 and the accompanying Comment. The fact that a particular creditor may reach generally exempt property by resorting to judicial process does not warrant its inclusion as an asset in determining whether the debtor is insolvent.

Since this Act is not an exclusive law on the subject of voidable transfers and obligations (see Comment (8) to § 4 (A.C.A. § 4-59-204), *infra*), it does not preclude the holder of a claim that may be collected by process against property generally exempt as to other creditors from obtaining relief from a transfer of such property that hinders, delays, or defrauds the holder of such a claim. Likewise the holder of an

unsecured claim enforceable against tenants by the entirety is not precluded by the Act from pursuing a remedy against a transfer of property held by the entirety that hinders, delays, or defrauds the holder of such a claim.

Nonbankruptcy law is the law of a state or federal law that is not part of the Bankruptcy Code, Title 11 of the United States Code. The definition of an "asset" thus does not include property that would be subject to administration for the benefit of creditors under the Bankruptcy Code unless it is subject under other applicable law, state or federal, to process for the collection of a creditor's claim against a single debtor.

(3) The definition of "claim" is derived from § 101(4) of the Bankruptcy Code. Since the purpose of this Act is primarily to protect unsecured creditors against transfers and obligations injurious to their rights, the words "claim" and "debt" as used in the Act generally have reference to an unsecured claim and debt. As the context may indicate, however, usage of the terms is not so restricted. See, e.g., §§ 1(1)(i)(B) (A.C.A. § 4-59-201(1)(i)(B)) and 1(8) (A.C.A. § 4-59-201(8)).

(4) The definition of "creditor" in combination with the definition of "claim" has substantially the same effect as the definition of "creditor" under § 1 of the Uniform Fraudulent Conveyance Act. As under that Act, the holder of an unliquidated tort claim or a contingent claim may be a creditor protected by this Act.

(5) The definition of "debt" is derived from § 101(11) of the Bankruptcy Code.

(6) The definition of "debtor" is new.

(7) The definition of "insider" is derived from § 101(28) of the Bankruptcy Code. The definition has been restricted in clauses (i)(C) (A.C.A. § 4-59-201(i)(C)), (ii)(E) (A.C.A. § 4-59-201(ii)(E)), and (iii)(D) (A.C.A. § 4-59-201(iii)(D)) to make clear that a partner is not an insider of an individual, corporation, or partnership if any of these latter three persons is only a limited partner. The definition of "insider" in the Bankruptcy Code does not purport to make a limited partner an insider of the partners or of the partnership with which the limited partner is associated, but it is susceptible of a contrary interpretation and one which would extend unduly the scope of the defined relationship when the limited partner is not a person in control

of the partnership. The definition of "insider" in this Act also differs from the definition in the Bankruptcy Code in omitting the reference in 11 U.S.C. § 101(28)(D) to an elected official or relative of such an official as an insider of a municipality. As in the Bankruptcy Code (see 11 U.S.C. § 102(3)), the word "includes" is not limiting, however. Thus, a court may find a person living with an individual for an extended time in the same household or as a permanent companion to have the kind of close relationship intended to be covered by the term "insider." Likewise, a trust may be found to be an insider of a beneficiary.

(8) The definition of "lien" is derived from paragraphs (30), (31), (43), and (45) of § 101 of the Bankruptcy Code, which define "judicial lien," "lien," "security interest," and "statutory lien" respectively.

(9) The definition of "person" is adapted from paragraphs (28) and (30) of § 1-201 of the Uniform Commercial Code, defining "organization" and "person" respectively.

(10) The definition of "property" is derived from § 1-201(33) of the Uniform Probate Code. Property includes both real and personal property, whether tangible or intangible, and any interest in property, whether legal or equitable.

(11) The definition of "relative" is derived from § 101(37) of the Bankruptcy Code but is explicit in its references to the spouse of a debtor in view of uncertainty as to whether the common law determines degrees of relationship by affinity.

(12) The definition of "transfer" is derived principally from § 101(48) of the Bankruptcy Code. The definition of "conveyance" in § 1 of the Uniform Fraudulent Conveyance Act was similarly comprehensive and the references in this Act to "payment of money, release, lease, and the creation of a lien or encumbrance" are derived from the Uniform Fraudulent Conveyance Act. While the definition in the Uniform Fraudulent Conveyance Act did not explicitly refer to an involuntary transfer, the decisions under that Act were generally consistent with an interpretation that covered such a transfer. See, e.g., *Hearn*, 45 St. Corp. v. *Jano*, 283 N.Y. 139, 27 N.E.2d 814, 128 A.L.R. 1285 (1940) (execution and foreclosure sales); *Lefkowitz v. Finklestein Trading Corp.*, 14 F.Supp. 898, 899 (S.D.N.Y. 1936) (execution sale); *Langan v. First Trust & Deposit*



Co., 277 App.Div. 1090, 101 N.Y.S.2d 36 (4th Dept. 1950), *aff'd* 302 N.Y. 932, 100 N.E.2d 189 (1951) (mortgage foreclosure); *Catabene v. Wallner*, 16 N.J. Super. 597, 602, 85 A.2d 300, 302 (1951) (mortgage foreclosure).

(13) The definition of "valid lien" is new.

A valid lien includes an equitable lien that may not be defeated by a judicial lien creditor. See, e.g., *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132, 136 (1962) (upholding a surety's equitable lien in respect to a fund owing a bankrupt contractor).

### Comment to Section 2 (A.C.A. § 4-59-202)

(1) Subsection (a) (A.C.A. § 4-59-202(a)) is derived from the definition of "insolvent" in § 101(29)(A) of the Bankruptcy Code. The definition in subsection (a) (A.C.A. § 4-59-202(a)) and the correlated definition of partnership insolvency in subsection (c) (A.C.A. § 4-59-202(c)) contemplate a fair valuation of the debts as well as the assets of the debtor. As under the definition of the same term in § 2 of the Uniform Fraudulent Conveyance Act exempt property is excluded from the computation of the value of the assets. See § 1(2) (A.C.A. § 4-59-201(2)) *supra*. For similar reasons interests in valid spendthrift trusts and interests in tenancies in the entireties that cannot be severed by a creditor of only one tenant are not included. See the Comment to § 1(2) (A.C.A. § 4-59-201(2)) *supra*. Since a valid lien also precludes an unsecured creditor from collecting the creditor's claim from the encumbered interest in a debtor's property, both the encumbered interest and the debt secured thereby are excluded from the computation of insolvency under this Act. See § 1(2) (A.C.A. § 4-59-201(2)) *supra* and subsection (e) (A.C.A. § 4-59-202(e)) of this section.

(2) Section 2(b) (A.C.A. § 4-59-202(b)) establishes a rebuttable presumption of insolvency from the fact of general nonpayment of debts as they become due. Such general nonpayment is a ground for the filing of an involuntary petition under § 303(h)(1) of the Bankruptcy Code. See also U.C.C. § 1-201(23), which declares a person to be "insolvent" who "has ceased to pay his debts in the ordinary course of business." The presumption imposes on the party against whom the presumption is directed the burden of proving that the nonexistence of insolvency as defined in § 2(a) (A.C.A. § 4-59-202(a)) is more probable than its existence. See Uniform Rules of Evidence (1974 Act), Rule 310(a). The 1974 Uniform Rule 301(a) conforms to

the Final Draft of Federal Rule 301 as submitted to the United States Supreme Court by the Advisory Committee on Federal Rules of Evidence. "The so-called 'bursting bubble' theory, under which a presumption vanishes upon the introduction of evidence which would support a finding of the nonexistence of the presumed fact, even though not believed is rejected as according presumptions too 'slight and evanescent' an effect." Advisory Committee's Note to Rule 301. See also 1 J. Weinstein & M. Berger, *Evidence* ¶ 301[01] (1982).

The presumption is established in recognition of the difficulties typically imposed on a creditor in proving insolvency in the bankruptcy sense, as provided in subsection (a) (A.C.A. § 4-59-202(a)). See generally Levit, *The Archaic Concept of Balance-Sheet Insolvency*, 47 *Am.Bankr.L.J.* 215 (1973). Not only is the relevant information in the possession of a non-cooperative debtor, but the debtor's records are more often than not incomplete and inaccurate. As a practical matter, insolvency is most cogently evidenced by a general cessation of payment of debts, as has long been recognized by the laws of other countries and is now reflected in the Bankruptcy Code. See Honsberger, *Failure to Pay One's Debts Generally as They Become Due: The Experience of France and Canada*, 54 *Am.Bankr.L.J.* 153 (1980); J. MacLachlan, *Bankruptcy* 13, 63-64, 436 (1956). In determining whether a debtor is paying its debts generally as they become due, the court should look at more than the amount and due dates of the indebtedness. The court should also take into account such factors as the number of the debtor's debts, the proportion of those debts not being paid, the duration of the nonpayment, and the existence of bona fide disputes or other special circumstances alleged to constitute an explana-

tion for the stoppage of payments. The court's determination may be affected by a consideration of the debtor's payment practices prior to the period of alleged nonpayment and the payment practices of the trade or industry in which the debtor is engaged. The case law that has developed under § 303(h)(1) of the Bankruptcy Code has not required a showing that a debtor has failed or refused to pay a majority in number and amount of his or her debts in order to prove general nonpayment of debts as they become due. See, e.g., *Hill v. Cargill, Inc.* (In re Hill), 8 B.R. 779, 3 C.B.C.2d 920 (Bk.D.Minn.1981) (nonpayment of three largest debts held to constitute general nonpayment, although small debts were being paid); *In re All Media Properties, Inc.*, 5 B.R. 126, 6 B.C.D. 586, 2 C.B.C.2d 449 (Bk.S.D. Tex.1980) (missing significant number of payments or regularly missing payments significant in amount said to constitute general nonpayment; missing payments on more than 50% of aggregate of claims said not to be required to show general nonpayment; nonpayment for more than 30 days after billing held to establish nonpayment of a debt when it is due); *In re Kreidler Import Corp.*, 4 B.R. 256, 6 B.C.D. 608, 2 C.B.C.2d 159 (Bk.D.Md.1980) (nonpayment of one debt constituting 97% of debtor's total indebtedness held to constitute general nonpayment). A presumption of insolvency does

not arise from nonpayment of a debt as to which there is genuine bona fide dispute, even though the debt is a substantial part of the debtor's indebtedness. Cf. 11 U.S.C. § 303(h)(1), as amended by § 426(b) of Public Law No. 98-882, the Bankruptcy Amendments and Federal Judgeship Act of 1984.

(3) Subsection (c) (A.C.A. § 4-59-202(c)) is derived from the definition of partnership insolvency in § 101(29)(B) of the Bankruptcy Code. The definition conforms generally to the definition of the same term in § 2(2) of the Uniform Fraudulent Conveyance Act.

(4) Subsection (d) (A.C.A. § 4-59-202(d)) follows the approach of the definition of "insolvency" in § 101(29) of the Bankruptcy Code by excluding from the computation of the value of the debtor's assets any value that can be realized only by avoiding a transfer of interest formerly held by the debtor or by discovery or pursuit of property that has been fraudulently concealed or removed.

(5) Subsection (e) (A.C.A. § 4-59-202(e)) is new. It makes clear the purpose not to render a person insolvent under this section by counting as a debt an obligation secured by property of the debtor that is not counted as an asset. See also Comments to §§ 1(2) (A.C.A. § 4-59-201(2)) and 2(a) (A.C.A. § 4-59-202(a)) *supra*.

### Comment to Section 3 (A.C.A. § 4-59-203)

(1) This section defines "value" as used in various contexts in this Act, frequently with a qualifying adjective. The word appears in the following sections:

4(a)(2) (A.C.A. § 4-59-204(a)(2)) ("reasonably equivalent value");

4(b)(8) (A.C.A. § 4-59-204(b)(8)) ("value... reasonably equivalent");

5(a) (A.C.A. § 4-59-205(a)) ("reasonably equivalent value");

5(b)\* ("present, reasonably equivalent value");

8(a) (A.C.A. § 4-59-208(a)) ("reasonably equivalent value");

8(b) (A.C.A. § 4-59-208(b)), (c) (A.C.A. § 4-59-208(c)), (d) (A.C.A. § 4-59-208(d)), and (e) (A.C.A. § 4-59-208(e)) ("value");

8(f)(1) (A.C.A. § 4-59-208(f)(1)) ("new value"); and

8(f)(3) (A.C.A. § 4-59-208(f)(3)) ("present value").

(2) Section 3(a) (A.C.A. § 4-59-203(a)) is adapted from § 548(d)(2)(A) of the Bankruptcy Code. See also § 3(a) of the Uniform Fraudulent Conveyance Act. The definition in Section 3 (A.C.A. § 4-59-203) is not exclusive. "Value" is to be determined in light of the purpose of the Act to protect a debtor's estate from being depleted to the prejudice of the debtor's unsecured creditors. Consideration having no utility from a creditor's viewpoint does not satisfy the statutory definition. The definition does not specify all the kinds of consideration that do not constitute value for the purposes of this Act — e.g., love and affection. See, e.g., *United States v. West*, 299 F.Supp. 661, 666 (D.Del. 1969).



(3) Section 3(a) (A.C.A. § 4-59-203(a)) does not indicate what is "reasonably equivalent value" for a transfer or obligation. Under this Act, as under § 548 (a)(2) of the Bankruptcy Code, a transfer for security is ordinarily for a reasonably equivalent value notwithstanding a discrepancy between the value of the asset transferred and the debt secured, since the amount of the debt is the measure of the value of the interest in the asset that is transferred. See, e.g., *Peoples-Pittsburgh Trust Co. v. Holy Family Polish Nat'l Catholic Church*, Carnegie, Pa., 341 Pa. 390, 19 A.2d 360 (1941). If, however, a transfer purports to secure more than the debt actually incurred or to be incurred, it may be found to be for less than a reasonably equivalent value. See, e.g., *In re Peoria Braumeister Co.*, 138 F.2d 520, 523 (7th Cir. 1943) (chattel mortgage securing a \$3,000 note held to be fraudulent when the debt secured was only \$2,500); *Hartford Acc. & Indemnity Co. v. Jirasek*, 254 Mich. 131, 140, 235 N.W. 836, 839 (1931) (quitclaim deed given as mortgage held to be fraudulent to the extent the value of the property transferred exceeded the indebtedness secured). If the debt is a fraudulent obligation under this Act, a transfer to secure it as well as the obligation would be vulnerable to attack as fraudulent. A transfer to satisfy or secure an antecedent debt owed an insider is also subject to avoidance under the conditions specified in Section 5(b)\* (A.C.A. § 4-59-205(b)).

(4) Section 3(a) of the Uniform Fraudulent Conveyance Act has been thought not to recognize that an unperformed promise could constitute fair consideration. See *McLaughlin*, Application of the Uniform Fraudulent Conveyance Act, 46 Harv.L.Rev. 404, 414 (1933). Courts construing these provisions of the prior law nevertheless have held unperformed promises to constitute value in a variety of circumstances. See, e.g., *Harper v. Lloyd's Factors, Inc.*, 214 F.2d 662 (2d Cir. 1954) (transfer of money for promise of factor to discount transferor's purchase-money notes given to fur dealer); *Schlecht v. Schlecht*, 168 Minn. 168, 176-77, 209 N.W. 883, 886-87 (1926) (transfer for promise to make repairs and improvements on transferor's homestead); *Farmer's Exchange Bank v. Oneida Motor Truck Co.*, 202 Wis. 266, 232 N.W. 536 (1930) (transfer in consideration of assumption of certain of

the transferor's liabilities); see also *Hummel v. Cernocky*, 161 F.2d 685 (7th Cir. 1947) (transfer in consideration of cash, assumption of a mortgage, payment of certain debts, and agreement to pay other debts). Likewise a transfer in consideration of a negotiable note discountable at a commercial bank, or the purchase from an established, solvent institution of an insurance policy, annuity, or contract to provide care and accommodations clearly appears to be for value. On the other hand, a transfer for an unperformed promise by an individual to support a parent or other transferor has generally been held voidable as a fraud on creditors of the transferor. See, e.g., *Springfield Ins. Co. v. Fry*, 267 F.Supp. 693 (N.D. Okla. 1967); *Sandler v. Parlapiano*, 236 App.Div. 70, 258 N.Y.Supp. 88 (1st Dep't 1932); *Warwick Municipal Employees Credit Union v. Higham*, 106 R.I. 363, 259 A.2d 852 (1969); *Hulsether v. Sanders*, 54 S.D. 412, 223 N.W. 335 (1929); *Cooper v. Cooper*, 22 Tenn.App. 473, 477, 124 S.W.2d 264, 267 (1939); Note, *Rights of Creditors in Property Conveyed in Consideration of Future Support*, 45 Iowa L.Rev. 546, 550-62 (1960). This Act adopts the view taken in the cases cited in determining whether an unperformed promise is value.

(5) Subsection (b) (A.C.A. § 4-59-203(b))\*\* rejects the rule of such cases as *Durrett v. Washington Nat. Ins. Co.*, 621 F.2d 201 (5th Cir. 1980) (nonjudicial foreclosure of a mortgage avoided as a fraudulent transfer when the property of an insolvent mortgagor was sold for less than 70% of its fair value; and *Abramson v. Lakewood Bank and Trust Co.*, 647 F.2d 547 (5th Cir.1981), cert. denied, 454 U.S. 1164 (1982) (nonjudicial foreclosure held to be fraudulent transfer if made without fair consideration). Subsection (b) (A.C.A. § 4-59-203(b))\*\* adopts the view taken in *Lawyers Title Ins. Corp. v. Madrid* (In re Madrid), 21 B.R. 424 (B.A.P. 9th Cir. 1982), aff'd on another ground, 725 F.2d 1197 (9th Cir.1984), that the price bid at a public foreclosure sale determines the fair value of the property sold. Subsection (b) (A.C.A. § 4-59-203(b))\*\* prescribes the effect of a sale meeting its requirements, whether the asset sold is personal or real property. The rule of this subsection applies to a foreclosure by sale of the interest of a vendee under an installment land

contract in accordance with applicable law that requires or permits the foreclosure to be effected by a sale in the same manner as the foreclosure of a mortgage. See G. Osborne, G. Nelson, & D. Whitman, *Real Estate Finance Law* 83-84, 95-97 (1979). The premise of the subsection is that "a sale of the collateral by the secured party as the normal consequence of default... [is] the safest way of establishing the fair value of the collateral ...." 2 G. Gilmore, *Security Interests in Personal Property* 1227 (1965).

If a lien given an insider for a present consideration is not perfected as against a subsequent bona fide purchaser or is so perfected after a delay following an extension of credit secured by the lien, foreclosure of the lien may result in a transfer for

an antecedent debt that is voidable under Section 5(b) (A.C.A. § 4-59-205(b)) *infra*. Subsection (b) (A.C.A. § 4-59-203(b))\*\* does not apply to an action under Section 4(a)(1) (A.C.A. § 4-59-204(a)(1)) to avoid a transfer or obligation because made or incurred with actual intent to hinder, delay, or defraud any creditor.

(6) Subsection (c) (A.C.A. § 4-59-203(c)) is an adaptation of § 547(c)(1) of the Bankruptcy Code. A transfer to an insider for an antecedent debt may be voidable under § 5(b) (A.C.A. § 4-59-205(b)) *infra*.

\* This language is not found in 5(b).

\*\* The version adopted in Arkansas is different from the Uniform Act.

#### Comment to Section 4 (A.C.A. § 4-59-204)

(1) Section 4(a)(1) (A.C.A. § 4-59-204(a)(1)) is derived from § 7 of the Uniform Fraudulent Conveyance Act. Factors appropriate for consideration in determining actual intent under paragraph (1) (A.C.A. § 4-59-204(a)(1)) are specified in subsection (b) (A.C.A. § 4-59-204(b)).

(2) Section 4(a)(2) (A.C.A. § 4-59-204(a)(2)) is derived from §§ 5 and 6 of the Uniform Fraudulent Conveyance Act but substitutes "reasonably equivalent value" for "fair consideration." The transferee's good faith was an element of "fair consideration" as defined in § 3 of the Uniform Fraudulent Conveyance Act, and lack of fair consideration was one of the elements of a fraudulent transfer as defined in four sections of the Uniform Act. The transferee's good faith is irrelevant to a determination of the adequacy of the consideration under this Act, but lack of good faith may be a basis for withholding protection of a transferee or obligee under § 8 (A.C.A. § 4-59-208) *infra*.

(3) Unlike the Uniform Fraudulent Conveyance Act as originally promulgated, this Act does not prescribe different tests when a transfer is made for the purpose of security and when it is intended to be absolute. The premise of this Act is that when a transfer is for security only, the equity or value of the asset that exceeds the amount of the debt secured remains available to unsecured creditors and thus cannot be regarded as the sub-

ject of a fraudulent transfer merely because of the encumbrance resulting from an otherwise valid security transfer. Disproportion between the value of the asset securing the debt and the size of the debt secured does not, in the absence of circumstances indicating a purpose to hinder, delay, or defraud creditors, constitute an impermissible hindrance to the enforcement of other creditors' rights against the debtor-transferor. Cf. U.C.C. § 9-311.

(4) Subparagraph (i) of § 4(a)(2) (A.C.A. § 4-59-204(a)(2)(i)) is an adaptation of § 5 of the Uniform Fraudulent Conveyance Act but substitutes "unreasonably small [assets] in relation to business or transaction" for "unreasonably small capital." The reference to "capital" in the Uniform Act is ambiguous in that it may refer to net worth or to the par value of stock or to the consideration received for stock issued. The special meanings of "capital" in corporation law have no relevance in the law of fraudulent transfers. The subparagraph focuses attention on whether the amount of all the assets retained by the debtor was inadequate, i.e., unreasonably small, in light of the needs of the business or transaction in which the debtor was engaged or about to engage.

(5) Subsection (b) (A.C.A. § 4-59-204(b)) is a nonexclusive catalogue of factors appropriate for consideration by the court in determining whether the debtor had an actual intent to hinder, delay, or



defraud one or more creditors. Proof of the existence of any one or more of the factors enumerated in subsection (b) (A.C.A. § 4-59-204(b)) may be relevant evidence as to the debtor's actual intent but does not create a presumption that the debtor has made a fraudulent transfer or incurred a fraudulent obligation. The list of factors includes most of the badges of fraud that have been recognized by the courts in construing and applying the Statute of 13 Elizabeth and § 7 of the Uniform Fraudulent Conveyance Act. Proof of the presence of certain badges in combination establishes fraud conclusively — i.e., without regard to the actual intent of the parties — when they concur as provided in § 4(a)(2) (A.C.A. § 4-59-204(a)(2)) or in § 5 (A.C.A. § 4-59-205). The fact that a transfer has been made to a relative or to an affiliated corporation has not been regarded as a badge of fraud sufficient to warrant avoidance when unaccompanied by any other evidence of fraud. The courts have uniformly recognized, however, that a transfer to a closely related person warrants close scrutiny of the other circumstances, including the nature and extent of the consideration exchanged. See 1 G. Glenn, *Fraudulent Conveyances and Preferences* § 307 (Rev. ed. 1940). The second, third, fourth, and fifth factors listed are all adapted from the classic catalogue of badges of fraud provided by Lord Coke in *Twyne's Case*, 3 Coke 80b, 76 Eng.Rep. 809 (Star Chamber 1601). Lord Coke also included the use of a trust and the recitation in the instrument of transfer that it "was made honestly, truly, and bona fide," but the use of the trust is fraudulent only when accompanied by elements or badges specified in this Act, and recitals of "good faith" can no longer be regarded as significant evidence of a fraudulent intent.

(6) In considering the factors listed in § 4(b) (A.C.A. § 4-59-204(b)) a court should evaluate all the relevant circumstances involving a challenged transfer or obligation. Thus the court may appropriately take into account all indicia negating as well as those suggesting fraud, as illustrated in the following reported cases:

(a) Whether the transfer or obligation was to an insider: *Salomon v. Kaiser* (In re Kaiser), 722 F.2d 1574, 1582-83 (2d Cir. 1983) (insolvent debtor's purchase of two residences in the name of his spouse and the creation of a

dummy corporation for the purpose of concealing assets held to evidence fraudulent intent); *Banner Construction Corp. v. Arnold*, 128 So.2d 893 (Fla. Dist. App. 1961) (assignment by one corporation to another having identical directors stockholders constituted a badge of fraud); *Travelers Indemnity Co. v. Cormaney*, 258 Iowa 237, 138 N.W.2d 50 (1965) (transfer between spouses said to be a circumstance that shed suspicion on the transfer and that with other circumstances warranted avoidance); *Hatheway v. Hanson*, 230 Iowa 386, 297 N.W. 824 (1941) (transfer from parent to child said to require a critical examination of surrounding circumstances, which together with other indicia of fraud, warranted avoidance); *Lumpkins v. McPhee*, 59 N.M. 442, 286 P.2d 299 (1955) (transfer from daughter to mother said to be indicative of fraud but transfer held not to be fraudulent due to adequacy of consideration and delivery of possession by transferor).

(b) Whether the transferor retained possession or control of the property after the transfer: *Harris v. Shaw*, 224 Ark. 150, 272 S.W.2d 53 (1954) (retention of property by transferor said to be a badge of fraud, and together with other badges, to warrant avoidance of transfer); *Stephens v. Reginstein*, 89 Ala. 561, 8 So. 68 (1890) (transferor's retention of control and management of property and business after transfer held material in determining transfer to be fraudulent); *Allen v. Massey*, 84 U.S. (17 Wall.) 351 (1872) (joint possession of furniture by transferor and transferee considered in holding transfer to be fraudulent); *Warner v. Norton*, 61 U.S. (20 How.) 448 (1857) (surrender of possession by transferor deemed to negate allegations of fraud).

(c) Whether the transfer or obligation was concealed or disclosed: *Walton v. First National Bank*, 13 Colo. 265, 22 P. 440 (1889) (agreement between the parties to conceal the transfer from the public said to be one of the strongest badges of fraud); *Warner v. Norton*, 61 U.S. (20 How.) 448 (1857) (although secrecy said to be a circumstance from which, when coupled with other badges, fraud may be inferred, transfer was held not to be fraudulent when made in good faith and transferor surrendered

possession); *W.T. Raleigh Co. v. Barnett*, 253 Ala. 433, 44 So.2d 585 (1950) (failure to record a deed in itself said not to evidence fraud, and transfer held not to be fraudulent).

(d) Whether, before the transfer was made or obligation was incurred, a creditor sued or threatened to sue the debtor: *Harris v. Shaw*, 224 Ark. 150, 272 S.W.2d 53 (1954) (transfer held to be fraudulent when causally connected to pendency of litigation and accompanied by other badges of fraud); *Pergrem v. Smith*, 255 S.W.2d 42 (Ky.App.1953) (transfer in anticipation of suit deemed to be a badge of fraud; transfer held fraudulent when accompanied by insolvency of transferor who was related to the transferee); *Bank of Sun Prairie v. Hovig*, 218 F.Supp. 769 (W.D.Ark.1963) (although threat or pendency of litigation said to be an indicator of fraud, transfer was held not to be fraudulent when adequate consideration and good faith were shown).

(e) Whether the transfer was of substantially all the debtor's assets: *Walbrun v. Babbitt*, 83 U.S. (16 Wall.) 577 (1872) (sale by insolvent retail shop owner of all his inventory in a single transaction held to be fraudulent); *Cole v. Mercantile Trust Co.*, 133 N.Y. 164, 30 N.E. 847 (1892) (transfer of all property before plaintiff could obtain a judgment held to be fraudulent); *Lumpkins v. McPhee*, 59 N.M. 442, 286 P.2d 299 (1955) (although transfer of all assets said to indicate fraud, transfer held not to be fraudulent because full consideration was paid and transferor surrendered possession).

(f) Whether the debtor had absconded: *In re Thomas*, 199 F. 214 (N.D.N.Y. 1912) (when the debtor collected all of his money and property with the intent to abscond, fraudulent intent was held to be shown).

(g) Whether the debtor had removed or concealed assets: *Bentley v. Young*, 210 F. 202 (S.D.N.Y.1914), *aff'd*, 223 F. 536 (2d Cir.1915) (debtor's removal of goods from store to conceal their whereabouts and to sell them held to render sale fraudulent); *Cioli v. Kenourgios*, 59 Cal.App. 690, 211 P. 838 (1922) (debtor's sale of all assets and shipment of proceeds out of the country held to be

fraudulent notwithstanding adequacy of consideration).

(h) Whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred: *Toomay v. Graham*, 151 S.W.2d 119 (Mo.App.1941) (although mere inadequacy of consideration said not to be a badge of fraud, transfer held to be fraudulent only when accompanied by badges of fraud); *Texas Sand Co. v. Shield*, 381 S.W.2d 48 (Tex.1964) (inadequate consideration said to be an indicator of fraud, and transfer held to be fraudulent because of inadequate consideration, pendency of suit, family relationship of transferee, and fact that all non-exempt property was transferred); *Weigel v. Wood*, 355 Mo. 11, 194 S.W.2d 40 (1946) (although inadequate consideration said to be a badge of fraud, transfer held not to be fraudulent when inadequacy not gross and not accompanied by any other badge; fact that transfer was from father to son not held sufficient to establish fraud).

(i) Whether the debtor was insolvent or became insolvent shortly after the transfer was made or obligation was incurred: *Harris v. Shaw*, 224 Ark. 150, 272 S.W.2d 53 (1954) (insolvency of transferor said to be a badge of fraud and transfer held fraudulent when accompanied by other badges of fraud); *Bank of Sun Prairie v. Hovig*, 218 F.Supp. 769 (W.D.Ark.1963) (although the insolvency of the debtor said to be a badge of fraud, transfer held not fraudulent when debtor was shown to be solvent, adequate consideration was paid, and good faith was shown, despite the pendency of suit); *Wareheim v. Bayliss*, 149 Md. 103, 131 A.2d 727 (1957) (although insolvency of debtor acknowledged to be an indicator of fraud, transfer held not to be fraudulent when adequate consideration was paid and whether the debtor was insolvent in fact was doubtful).

(j) Whether the transfer occurred shortly before or shortly after a substantial debt was incurred: *Commerce Bank of Lebanon v. Halladale A Corp.*, 618 S.W.2d 288, 292 (Mo.App.1981) (when transferors incurred substantial debts near in time to the transfer, trans-



fer was held to be inadequate consideration, close family relationship, the debtor's retention of possession, and the fact that almost all the debtors' property was transferred).

(7) The effect of the two transfers described in § 4(b)(11) (A.C.A. § 4-59-204(b)(11)), if not avoided, may be to permit a debtor and a lienor to deprive the debtor's unsecured creditors of access to the debtor's assets for the purpose of collecting their claims while the debtor, the debtor's affiliate or insider, and the lienor arrange for the beneficial use or disposition of the assets in accordance with their interests. The kind of disposition sought to be reached here is exemplified by that found in *Northern Pacific Co. v. Boyd*, 228 U.S. 482 (1913), the leading case in establishing the absolute priority doctrine in reorganization law. There the Court held that a reorganization whereby the secured creditors and the management-owners retained their economic interests in a railroad through a foreclosure that cut off claims of unsecured creditors against its assets was in effect a fraudulent disposition (id. at 502-05). See Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 Va.L.Rev. 541, 693 (1933). For cases in which an analogous injury to unsecured creditors was inflicted by a lienor and a debtor, see *Jackson v. Star Sprinkler Corp. of Florida*, 575 F.2d 1223, 1231-34 (8th Cir.1978); *Heath v. Helmick*, 173 F.2d 157, 161-62 (9th Cir.1949); *Toner v. Nuss*, 234 F.S. 457, 461-62 (E.D.Pa.1964); and see *In re Spotless Tavern Co., Inc.*, 4 F.Supp. 752, 753, 755 (D.Md.1933).

(8) Nothing in § 4(b) (A.C.A. § 4-59-204(b)) is intended to affect the application of §§ 2-402(2), 9-205, 9-301, or 6-105 of the Uniform Commercial Code. Section 2-402(2) recognizes the generally prevailing rule that retention of possession of goods by a seller may be fraudulent but limits the application of the rule by negating any imputation of fraud from "retention of possession in good faith and current course of trade by a merchant-seller for a commercially reasonable time after a sale or identification." Section 9-205 explicitly negates any imputation of fraud from the grant of liberty by a secured creditor to a debtor to use, commingle, or dispose of personal property collateral or to account for its proceeds. The section recognizes that it does not relax prevailing requirements for delivery of possession by a pledgor. Moreover, the section does not mitigate the general requirement of § 9-301(1)(b) that a nonpossessory security interest in personal property must be accompanied by a notice-filing to be effective against a levying creditor. Finally, like the Uniform Fraudulent Conveyance Act this Act does not pre-empt the statutes governing bulk transfers, such as Article 6 of the Uniform Commercial Code. Compliance with the cited sections of the Uniform Commercial Code does not, however, insulate a transfer or obligation from avoidance. Thus a sale by an insolvent debtor for less than a reasonably equivalent value would be voidable under this Act notwithstanding compliance with the Uniform Commercial Code.

### Comment to Section 5 (A.C.A. § 4-59-205)

(1) Subsection (a) (A.C.A. § 4-59-205(a)) is derived from § 4 of the Uniform Fraudulent Conveyance Act. It adheres to the limitation of the protection of that section to a creditor who extended credit before the transfer or obligation described. As pointed out in Comment (2) accompanying § 4 (A.C.A. § 4-59-204), this Act substitutes "reasonably equivalent value" for "fair consideration."

(2) Subsection (b) (A.C.A. § 4-59-205(b)) renders a preferential transfer — i.e., a transfer by an insolvent debtor for or on account of an antecedent debt — to an insider vulnerable as a fraudulent

transfer when the insider had reasonable cause to believe that the debtor was insolvent. This subsection adopts for general application the rule of such cases as *Jackson Sound Studios, Inc. v. Travis*, 473 F.2d 503 (5th Cir.1973) (security transfer of corporation's equipment to corporate principal's mother perfected on eve of bankruptcy of corporation held to be fraudulent); *In re Lamie Chemical Co.*, 296 F.2d 44 (4th Cir.1924) (corporate preference to corporate officers and directors held voidable by receiver when corporation was insolvent or nearly so and directors had already voted for liquidation); *Stuart v.*

Larson, 298 F. 223 (8th Cir. 1924), noted 38 Harv. L. Rev. 521 (1925) (corporate preference to director held voidable). See generally 2 G. Glenn, *Fraudulent Conveyances and Preferences* 386 (Rev. ed. 1940). Subsection (b) (A.C.A. § 4-59-205(b)) overrules such cases as *Epstein v. Goldstein*, 107 F.2d 755, 757 (2d Cir. 1939) (transfer by insolvent husband to wife to secure his debt to her sustained against attack by husband's trustee); *Hartford Accident & Indemnity Co. v. Jirasek*, 254 Mich. 131, 139, 235 N.W. 836, 839 (1931) (mortgage given by debtor to his brother to secure an antecedent debt owed the brother sustained as not fraudulent).

(3) Subsection (b) (A.C.A. § 4-59-205(b)) does not extend as far as § 8(a) of the Uniform Fraudulent Conveyance Act and § 548(b) of the Bankruptcy Code in

rendering voidable a transfer or obligation incurred by an insolvent partnership to a partner, who is an insider of the partnership. The transfer to the partner is not vulnerable to avoidance under § 4(b) (A.C.A. § 4-59-204(b)) unless the transfer was for an antecedent debt and the partner had reasonable cause to believe that the partnership was insolvent. The cited provisions of the Uniform Fraudulent Conveyance Act and the Bankruptcy Act make any transfer by an insolvent partnership to a partner voidable. Avoidance of the partnership transfer without reference to the partner's state of mind and the nature of the consideration exchanged would be unduly harsh treatment of the creditors of the partner and unduly favorable to the creditors of the partnership.

### Comment to Section 6 (A.C.A. § 4-59-206)

(1) One of the uncertainties in the law governing the avoidance of fraudulent transfers and obligations is the difficulty of determining when the cause of action arises. Subsection (b)\* clarifies this point in time. For transfers of real estate section 6(1) (A.C.A. § 4-59-206(1)) fixes the time as the date of perfection against a good faith purchaser from the transferor and for transfers of fixtures and assets constituting personalty, the time is fixed as the date of perfection against a judicial lien creditor not asserting rights under this Act. Perfection typically is effected by notice-filing, recordation, or delivery of unequivocal possession. See U.C.C. §§ 9-302, 9-304, and 9-305 (security interest in personal property perfected by notice-filing or delivery of possession to transferee); 4 American Law of Property §§ 17.10-17.12 (1952) (recordation of transfer or delivery of possession to grantee required for perfection against bona fide purchaser from grantor). The provision for postponing the time a transfer is made until its perfection is an adaptation of § 548(d)(1), of the Bankruptcy Code. When no steps are taken to perfect a transfer that applicable law permits to be perfected, the transfer is deemed by paragraph (2) (A.C.A. § 4-59-206(2)) to be perfected immediately before the filing of an action to avoid it; without such a provision to cover that eventuality, an unperfected transfer

would arguably be immune to attack. Some transfers — e.g., an assignment of a bank account, creation of a security interest in money, or execution of a marital or premarital agreement for the disposition of property owned by the parties to the agreement — may not be amenable to perfection as against a bona fide purchaser or judicial lien creditor. When a transfer is not perfectible as provided in paragraph (1) (A.C.A. § 4-59-206(1)), the transfer occurs for the purpose of this Act when the transferor effectively parts with an interest in the asset as provided in § 1(12) (A.C.A. § 4-59-201(12)) *supra*.

(2) Paragraph (4) (A.C.A. § 4-59-206(4)) requires the transferor to have rights in the asset transferred before the transfer is made for the purpose of this section. This provision makes clear that its purpose may not be circumvented by notice-filing or recordation of a document evidencing an interest in an asset to be acquired in the future. Cf. Bankruptcy Code § 547(e); U.C.C. § 9-203(1)(c).

(3) Paragraph (5) (A.C.A. § 4-59-206(5)) is new. It is intended to resolve uncertainty arising from *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 989-91, 997 (2d Cir. 1981), insofar as that case holds that an obligation of guaranty may be deemed to be incurred when advances covered by the guaranty are made rather than when the guaranty first



became effective between the parties. Compare *Rosenberg, Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U.Pa.L.Rev. 235, 256-57 (1976).

An obligation may be avoided as fraudulent under this Act if it is incurred under the circumstances specified in § 4(a) (A.C.A. § 4-59-204(a)) or § 5(a) (A.C.A. § 4-59-205(a)). The debtor may receive

reasonably equivalent value in exchange for an obligation incurred even though the benefit to the debtor is indirect. See *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d at 991-92; *Williams v. Twin City Co.*, 251 F.2d 678, 681 (9th Cir. 1958); *Rosenberg*, *supra* at 243-46.

\* There is no subsection (b) in section 6.

### Comment to Section 7 (A.C.A. § 4-59-207)

(1) This section is derived from §§ 9 and 10 of the Uniform Fraudulent Conveyance Act. Section 9 of that Act specified the remedies of creditors whose claims have matured, and § 10 enumerated the remedies available to creditors whose claims have not matured. A creditor holding an unmatured claim may be denied the right to receive payment for the proceeds of a sale on execution until his claim has matured, but the proceeds may be deposited in court or in an interest-bearing account pending the maturity of the creditor's claim. The remedies specified in this section are not exclusive.

(2) The availability of an attachment or other provisional remedy has been restricted by amendments of statutes and rules of procedure to reflect views of the Supreme Court expressed in *Sniadach v. Family Finance Corp. of Bay View*, 395 U.S. 337 (1969), and its progeny. This judicial development and the procedural changes that followed in its wake do not preclude resort to attachment by a creditor in seeking avoidance of a fraudulent transfer or obligation. See, e.g., *Britton v. Howard Sav. Bank*, 727 F.2d 315, 317-20 (3d Cir.1984); *Computer Sciences Corp. v. Sci-Tek Inc.*, 367 A.2d 658, 661 (Del. Super. 1976); *Great Lakes Carbon Corp. v. Fontana*, 54 A.D.2d 548, 387 N.Y.S.2d 115 (1st Dep't 1976). Section 7(a)(2) (A.C.A. § 4-59-207(a)(2)) continues the authorization for the use of attachment contained in § 9(b) of the Uniform Fraudulent Conveyance Act, or of a similar provisional remedy, when the state's procedure provides therefor, subject to the constraints imposed by the due process clauses of the United States and state constitutions.

(3) Subsections (a) and (b) of § 10 of the Uniform Fraudulent Conveyance Act authorized the court, in an action on a fraud-

ulent transfer or obligation, to restrain the defendant from disposing of his property, to appoint a receiver to take charge of his property, or to make any order the circumstances may require. Section 10, however, applied only to a creditor whose claim was unmatured. There is no reason to restrict the availability of these remedies to such a creditor, and the courts have not so restricted them. See, e.g., *Lipskey v. Voloshen*, 155 Md. 139, 143-45, 141 Atl. 402, 404-05 (1928) (judgment creditor granted injunction against disposition of property by transferee, but appointment of receiver denied for lack of sufficient showing of need for such relief); *Matthews v. Schusheim*, 36 Misc.2d 918, 922-23, 235 N.Y.S.2d 973, 976-77, 991-92 (Sup.Ct. 1962) (injunction and appointment of receiver granted to holder of claims for fraud, breach of contract, and alimony arrearages; whether the creditor's claim was mature said to be immaterial); *Oliphant v. Moore*, 155 Tenn. 359, 362-63, 293 S.W. 541, 542 (1927) (tort creditor granted injunction restraining alleged tortfeasor's disposition of property).

(4) As under the Uniform Fraudulent Conveyance Act, a creditor is not required to obtain a judgment against the debtor-transferor or to have a matured claim in order to proceed under subsection (a) (A.C.A. § 4-59-207(a)). See § 1(3) (A.C.A. § 4-59-201(3)) and (4) (A.C.A. § 4-59-201(4)) *supra*; *American Surety Co. v. Conner*, 251 N.Y. 1, 166 N.E. 783, 65 A.L.R. 244 (1929); 1 G. Glenn, *Fraudulent Conveyances and Preferences* 129 (Rev.ed.1940).

(5) The provision in subsection (b) (A.C.A. § 4-59-207(b)) for a creditor to levy execution on a fraudulently transferred asset continues the availability of a remedy provided in § 9(b) of the Uniform

Fraudulent Conveyance Act. See, e.g., *Doland v. Burns Lbr. Co.*, 156 Minn. 238, 194 N.W. 636 (1923); *Montana Ass'n of Credit Management v. Hegert*, 181 Mont. 442, 449, 453, 593 P.2d 1059, 1063, 1065 (1979); *Corbett v. Hunter*, 292 Pa.Super. 123, 128, 436 A.2d 1036, 1038 (1981); see also *American Surety Co. v. Conner*, 251 N.Y. 1, 6, 166 N.E. 783, 784, 65 A.L.R. 244, 247 (1929) ("In such circumstances he [the creditor] might find it necessary to indemnify the sheriff and, when the seizure was erroneous, assumed the risk of error"); *McLaughlin, Application of the Uniform Fraudulent Conveyance Act*, 46 Harv.L.Rev. 404, 441-42 (1933).

(6) The remedies specified in § 7 (A.C.A. § 4-59-207), like those enumer-

ated in §§ 9 and 10 of the Uniform Fraudulent Conveyance Act, are cumulative. *Lind v. O. N. Johnson Co.*, 204 Minn. 30, 40, 282 N.W. 661, 667, 119 A.L.R. 940 (1939) (Uniform Fraudulent Conveyance Act held not to impair or limit availability of the "old practice" of obtaining judgment and execution returned unsatisfied before proceeding in equity to set aside a transfer); *Conemaugh Iron Works Co. v. Delano Coal Co., Inc.*, 298 Pa. 182, 186, 148 A. 94, 95 (1929) (Uniform Fraudulent Conveyance Act held to give an "additional optional remedy" and not to "deprive a creditor of the right, as formerly, to work out his remedy at law"); 1 G. Glenn, *Fraudulent Conveyances and Preferences* 120, 130, 150 (Rev. ed. 1940).

### Comment to Section 8 (A.C.A. § 4-59-208)

(1) Subsection (a) (A.C.A. § 4-59-208(a)) states the rule that applies when the transferee establishes a complete defense to the action for avoidance based on Section 4(a)(1) (A.C.A. § 4-59-204(a)(1)). The subsection is an adaptation of the exception stated in § 9 of the Uniform Fraudulent Conveyance Act. The person who invokes this defense carries the burden of establishing good faith and the reasonable equivalence of the consideration exchanged. *Chorost v. Grand Rapids Factory Showrooms, Inc.*, 77 F.Supp. 276, 280 (D.N.J. 1948), *aff'd* 172 F.2d 327, 329 (3d Cir. 1949).

(2) Subsection (b) (A.C.A. § 4-59-208(b)) is derived from § 550(a) of the Bankruptcy Code. The value of the asset transferred is limited to the value of the levyable interest of the transferor, exclusive of any interest encumbered by a valid lien. See § 1(2) (A.C.A. § 4-59-201(2)) *supra*.

The requirement of § 550(b)(1) of the Bankruptcy Code that a transferee be "without knowledge of the voidability of the transfer" in order to be protected has been omitted as inappropriate. Knowledge of the facts rendering the transfer voidable would be inconsistent with the good faith that is required of a protected transferee. Knowledge of the voidability of a transfer would seem to involve a legal conclusion. Determination of the voidability of a transfer ought not to require the court to inquire into the legal sophistication of the transferee.

(3) Subsection (c) (A.C.A. § 4-59-208(c)) is new. The measure of the recovery of a defrauded creditor against a fraudulent transferee is usually limited to the value of the asset transferred at the time of the transfer. See, e.g., *United States v. Fernon*, 640 F.2d 609, 611 (5th Cir. 1981); *Hamilton Nat'l Bank of Boston v. Halstead*, 134 N.Y. 520, 31 N.E. 900 (1892); *cf. Buffum v. Peter Barceloux Co.*, 289 U.S. 227 (1932) (transferee's objection to trial court's award of highest value of asset between the date of the transfer and the date of the decree of avoidance rejected because an award measured by value as of time of the transfer plus interest from that date would have been larger). The premise of § 8(c) (A.C.A. § 4-59-208(c)) is that changes in value of the asset transferred that occur after the transfer should ordinarily not affect the amount of the creditor's recovery. Circumstances may require a departure from that measure of the recovery, however, as the cases decided under the Uniform Fraudulent Conveyance Act and other laws derived from the Statute of 13 Elizabeth illustrate. Thus, if the value of the asset at the time of levy and sale to enforce the judgment of the creditor has been enhanced by improvements of the asset transferred or discharge of liens on the property, a good faith transferee should be reimbursed for the outlay for such a purpose to the extent the sale proceeds were increased thereby. See



Bankruptcy Code § 550(d); *Janson v. Schier*, 375 A.2d 1159, 1160 (N.H. 1977); *Anno.*, 8 A.L.R. 527 (1920). If the value of the asset has been diminished by severance and disposition of timber or minerals or fixtures, the transferee should be liable for the amount of the resulting reduction. See *Damazo v. Wahby*, 269 Md. 252, 257, 305 A.2d 138, 142 (1973). If the transferee has collected rents, harvested crops, or derived other income from the use or occupancy of the asset after the transfer, the liability of the transferee should be limited in any event to the net income after deduction of the expense incurred in earning the income. *Anno.*, 60 A.L.R.2d 593 (1958). On the other hand, adjustment for the equities does not warrant an award to the creditor of consequential damages alleged to accrue from mismanagement of the asset after the transfer.

(4) Subsection (d) (A.C.A. § 4-59-208(d)) is an adaptation of § 548(c) of the Bankruptcy Code. An insider who receives property or an obligation from an insolvent debtor as security for or in satisfaction of an antecedent debt of the transferor or obligor is not a good faith transferee or obligee if the insider has reasonable cause to believe that the debtor was insolvent at the time the transfer was made or the obligation was incurred.

(5) Subsection (e)(1) (A.C.A. § 4-59-208(e)(1)) rejects the rule adopted in *Darby v. Atkinson* (*In re Farris*), 415 F.Supp. 33, 39-41 (W.D.Okla. 1976), that termination of a lease on default in accordance with its terms and applicable law may constitute a fraudulent transfer. Subsection (e)(2) (A.C.A. § 4-59-208(e)(2)) protects a transferee who acquires a debtor's interest in an asset as a result of the enforcement of a secured creditor's rights pursuant to and in compliance with the provisions of Part 5 of Article 9 of the Uniform Commercial Code. Cf. *Calaiaro v. Pittsburgh Nat'l Bank* (*In re Ewing*), 33 B.R. 288, 9 C.B.C.2d 526, CCH B.L.R. ¶ 69,460 (Bk.W.D.Pa. 1983) (sale of pledged stock held subject to avoidance as fraudulent transfer in § 548 of the Bankruptcy Code), *rev'd*, 36 B.R. 476 (W.D.Pa. 1984) (transfer held not voidable because deemed to have occurred more than one year before bankruptcy petition filed). Although a secured creditor may enforce rights in collateral without a sale under

§ 9-502 or § 9-505 of the Code\*, the creditor must proceed in good faith (U.C.C. § 9-103) and in a "commercially reasonable" manner. The "commercially reasonable" constraint is explicit in U.C.C. § 9-502(2) and is implicit in § 9-505. See 2 G. Gilmore, *Security Interests in Personal Property* 1224-27 (1965).

(6) Subsection (f) (A.C.A. § 4-59-208(f)) provides additional defenses against the avoidance of a preferential transfer to an insider under § 5(b) (A.C.A. § 4-59-205(b)).

Paragraph (1) (A.C.A. § 4-59-208(f)(1)) is adapted from § 547(c)(4) of the Bankruptcy Code, which permits a preferred creditor to set off the amount of new value subsequently advanced against the recovery of a voidable preference by a trustee in bankruptcy to the debtor without security. The new value may consist not only of money, goods, or services delivered on unsecured credit but also of the release of a valid lien. See, e.g., *In re Ira Haupt & Co.*, 424 F.2d 722, 724 (2d Cir. 1970); *Baranow v. Gilbrator Factors Corp.* (*In re Hygrade Envelope Co.*), 393 F.2d 60, 65-67 (2d Cir.), cert. denied, 393 U.S. 837 (1968); *In re John Morrow & Co.*, 134 F. 686, 688 (S.D. Ohio 1901). It does not include an obligation substituted for a prior obligation. If the insider receiving the preference thereafter extends new credit to the debtor but also takes security from the debtor, the injury to the other creditors resulting from the preference remains undiminished by the new credit. On the other hand, if a lien taken to secure the new credit is itself voidable by a judicial lien creditor of the debtor, the new value received by the debtor may appropriately be treated as unsecured and applied to reduce the liability of the insider for the preferential transfer.

Paragraph (2) (A.C.A. § 4-59-208(f)(2)) is derived from § 547(c)(2) of the Bankruptcy Code which excepts certain payments made in the ordinary course of business or financial affairs from avoidance by the trustee in bankruptcy as preferential transfers. Whether a transfer was in the "ordinary course" requires a consideration of the pattern of payments or secured transactions engaged in by the debtor and the insider prior to the transfer challenged under § 5(b) (A.C.A. § 4-59-205(b)). See *Tait & Williams, Bankruptcy Preference Laws: The Scope of*

Section 547(c)(2), 99 Banking L.J. 55, 63-66 (1982). The defense provided by paragraph (2) (A.C.A. § 4-59-208(f)(2)) is available, irrespective of whether the debtor or the insider or both are engaged in business, but the prior conduct or practice of both the debtor and the insider-transferee is relevant.

Paragraph (3) (A.C.A. § 4-59-208(f)(3)) is new and reflects a policy judgment that an insider who has previously extended credit to a debtor should not be deterred from extending further credit to the debtor in a good faith effort to save the debtor from a forced liquidation in bankruptcy or otherwise. A similar rationale has sustained the taking of security from an insolvent debtor for an advance to

enable the debtor to stave off bankruptcy and extricate itself from financial stringency. *Blackman v. Betchel*, 80 F.2d 505, 508-09 (8th Cir. 1935); *Olive v. Tyler* (In re Chelan Land Co.) 257 F. 497, 5 A.L.R. 561 (9th Cir. 1919); In re Robin Bros. Bakeries, Inc., 22 F.S. 662, 663-64 (N.D.Ill. 1937); see *Dean v. Davis*, 242 U.S. 438, 444 (1917). The amount of the present value given, the size of the antecedent debt secured, and the likelihood of success for the rehabilitative effort are relevant considerations in determining whether the transfer was in good faith.

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\*"Code" refers to the Uniform Commercial Code.

### Comment to Section 9 (A.C.A. § 4-59-209)

(1) This section is new. Its purpose is to make clear that lapse of the statutory periods prescribed by the section bars the right and not merely the remedy. See Restatement of Conflict of Laws 2d § 143 Comments (b) & (c) (1971). The section rejects the rule applied in *United States v. Gleneagles Inv. Co.*, 565 F.S. 556, 583 (M.D.Pa. 1983) (state statute of limitations held not to apply to action by United States based on Uniform Fraudulent Conveyance Act).

(2) Statutes of limitations applicable to the avoidance of fraudulent transfers and obligations vary widely from state to state and are frequently subject to uncertainties in their application. See Hesson, *The Statute of Limitations in Actions to Set Aside Fraudulent Conveyances and in Actions Against Directors by Creditors of Corporations*, 32 Cornell L.Q. 223 (1946);

76 A.L.R. 864 (1932), 128 A.L.R. 1289 (1940), 133 A.L.R. 1311 (1941), 14 A.L.R.2d 598 (1950), and 100 A.L.R.2d 1094 (1965). Together with § 6 (A.C.A. § 4-59-206), this section should mitigate the uncertainty and diversity that have characterized the decisions applying the statute of limitations to actions to fraudulent transfers and obligations. The periods described apply, whether the action under this Act is brought by the creditor defrauded or by a purchaser at a sale on execution levied pursuant to § 7(b) (A.C.A. § 4-59-207(b)) and whether the action is brought against the original transferee or subsequent transferee. The prescription of statutory periods of limitation does not preclude the barring of an avoidance action for laches. See § 10 (A.C.A. § 4-59-210) and the accompanying Comment *infra*.

### Comment to Section 10 (A.C.A. § 4-59-210)

This section is derived from § 11 of the Uniform Fraudulent Conveyance Act and § 1-103 of the Uniform Commercial Code. The section adds a reference to "laches" in recognition of the particular appropriateness of the application of this equitable doctrine to an untimely action to avoid a fraudulent transfer. See *Louis Dreyfus Corp. v. Butler*, 496 F.2d 806, 808 (6th Cir. 1974) (action to avoid transfers to debtor's

wife when debtor was engaged in speculative business held to be barred by laches or applicable statutes of limitations); *Cooch v. Grier*, 30 Del.Ch. 255, 265-66, 59 A.2d 282, 287-88 (1948) (action under the Uniform Fraudulent Conveyance Act held barred by laches when the creditor was chargeable with inexcusable delay and the defendant was prejudiced by the delay).



**Comment to Section 13 (A.C.A. § 4-59-213)**

If enacted by this State, the Uniform Fraudulent Conveyance Act should be listed among the statutes repealed.

**UNIFORM WAREHOUSE RECEIPTS ACT**  
**(§ 4-59-401 ET SEQ.)**

**Uniform Commercial Code**

The Uniform Commercial Code, approved by the National Conference of Commissioners on Uniform State Laws in 1951, contains in Article 7 thereof, provisions relating to warehouse receipts and other documents of title, which derived in part from the Uniform Warehouse Receipts Act. Many sections of this Act are probably superseded by the Uniform Commercial Code.\* The Uniform Commercial Code has been adopted in Kentucky, Massachusetts and Pennsylvania.

See statutory notes relating to such states, above. For text of the Uniform Commercial Code provisions relating to warehouse receipts, see 1957 Official Text of Uniform Commercial Code, published in pamphlet form, and the 1958 supplement thereto.

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\*Language added by the Arkansas Code Revision Commission.

**Commissioner's Note to Section 50 (A.C.A. § 4-59-401)**

To insure the fundamental basis on which the value of negotiable receipts must rest it seemed necessary to punish criminally any misrepresentation or fraud

in regard to the existence of the goods behind the receipt. Other obvious frauds are aimed at by the following five sections.

**Commissioner's Note to Section 51 (A.C.A. § 4-59-402)**

See note to section 50 (A.C.A. § 4-59-401).

**Commissioner's Note to Section 52 (A.C.A. § 4-59-403)**

See note to section 50 (A.C.A. § 4-59-401).

**Commissioner's Note to Section 53 (A.C.A. § 4-59-404)**

See note to section 50 (A.C.A. § 4-59-401).

**Commissioner's Note to Section 54 (A.C.A. § 4-59-405)**

See note to section 50 (A.C.A. § 4-59-401).

**Commissioner's Note to Section 55 (A.C.A. § 4-59-406)**

See note to section 50 (A.C.A. § 4-59-401).



## UNIFORM TRADE SECRETS ACT (§ 4-75-601 ET SEQ.)

**A.C.R.C. Notes.** The Arkansas version of this act does not follow the same section order as the uniform law. The comments

set out below follow the section order of the uniform law and, consequently, do not appear in A.C.A. order.

### Commissioners' Prefatory Note

A valid patent provides a legal monopoly for seventeen years in exchange for public disclosure of an invention. If, however, the courts ultimately decide that the Patent Office improperly issued a patent, an invention will have been disclosed to competitors with no corresponding benefit. In view of the substantial number of patents that are invalidated by the courts, many businesses now elect to protect commercially valuable information through reliance upon the state law of trade secret protection. *Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470 (1974), which establishes that neither the Patent Clause of the United States Constitution nor the federal patent laws pre-empt state trade secret protection for patentable or unpatentable information, may well have increased the extent of this reliance.

The recent decision in *Aronson v. Quick Point Pencil Co.*, 99 S.Ct. 1096, 201 USPQ 1 (1979) reaffirmed *Kewanee* and held that federal patent law is not a barrier to a contract in which someone agrees to pay a continuing royalty in exchange for the disclosure of trade secrets concerning a product.

Notwithstanding the commercial importance of state trade secret law to interstate business, this law has not developed satisfactorily. In the first place, its development is uneven. Although there typically are a substantial number of reported decisions in states that are commercial centers, this is not the case in less populous and more agricultural jurisdictions. Secondly, even in states in which there has been significant litigation, there is undue uncertainty concerning the parameters of trade secret protection, and the appropriate remedies for misappropriation of a trade secret. One commentator observed:

"Under technological and economic pressures, industry continues to rely on

trade secret protection despite the doubtful and confused status of both common law and statutory remedies. Clear, uniform trade secret protection is urgently needed...."

Comment, "Theft of Trade Secrets: The Need for a Statutory Solution", 120 U.Pa.L.Rev. 378, 380-81 (1971).

In spite of this need, the most widely accepted rules of trade secret law, § 757 of the Restatement of Torts, were among the sections omitted from the Restatement of Torts, 2d (1978).

The Uniform Act codifies the basic principles of common law trade secret protection, preserving its essential distinctions from patent law. Under both the Act and common law principles, for example, more than one person can be entitled to trade secret protection with respect to the same information, and analysis involving the "reverse engineering" of a lawfully obtained product in order to discover a trade secret is permissible. Compare Uniform Act, section 1(2) (A.C.A. § 4-75-601(2)) (misappropriation means acquisition of a trade secret by means that should be known to be improper and unauthorized disclosure or use of information that one should know is the trade secret of another) with *Miller v. Owens-Illinois, Inc.*, 187 USPQ 47, 48 (D.Md.1975) (alternative holding) (prior, independent discovery a complete defense to liability for misappropriation) and *Wesley-Jessen, Inc. v. Reynolds*, 182 USPQ 135, 144-45 (N.D.Ill.1974) (alternative holding) (unrestricted sale and lease of camera that could be reversed engineered in several days to reveal alleged trade secrets preclude relief for misappropriation).

For liability to exist under this Act, a section 1(4) (A.C.A. § 4-75-601(4)) trade secret must exist and either a person's acquisition of the trade secret, disclosure of the trade to others, or use of the trade

secret must be improper under section 1(2) (A.C.A. § 4-75-601(2)). The mere copying of an unpatented item is not actionable.

Like traditional trade secret law, the Uniform Act contains general concepts. The contribution of the Uniform Act is substitution of unitary definitions of trade secret and trade secret misappropriation,

and a single statute of limitations for the various property, quasi-contractual, and violation of fiduciary relationship theories of noncontractual liability utilized at common law. The Uniform Act also codifies the results of the better reasoned cases concerning the remedies for trade secret misappropriation.

### **The History of the Special Committee on the Uniform Trade Secrets Act**

On February 17, 1968, the Conference's subcommittee on Scope and Program reported to the Conference's Executive Committee as follows:

"14. Uniform Trade Secrets Protection Act.

This matter came to the subcommittee from the Patent Law Section of the American Bar Association from President Pierce, Commissioner Joiner and Allison Dunham. It appears that in 1966 the Patent Section of the American Bar Association extensively discussed a resolution to the effect that 'the ABA favors the enactment of a uniform state law to protect against the wrongful disclosure or wrongful appropriation of trade secrets, know-how or other information maintained in confidence by another.' It was decided, however, not to put such a resolution to a vote at that time but that the appropriate Patent Section Committee would further consider the problem. In determining what would be appropriate for the Conference to do at this juncture, the following points should be considered:

(1) At the present much is going on by way of statutory development, both federally and in the states.

(2) There is a fundamental policy conflict still unresolved in that the current state statutes that protect trade secrets tend to keep innovations secret, while our federal patent policy is generally designed to encourage public disclosure of innovations. It may be possible to devise a sensible compromise between these two basic policies that will work, but to do so demands coordination of the statutory reform efforts of both the federal government and the states.

(3) The Section on Patents, the ABA group that is closest to this prob-

lem, is not yet ready to take a definite position.

It is recommended that a special committee be appointed to investigate the question of the drafting of a uniform act relating to trade secret protection and to establish liaison with the Patent Law Section, the Corporation, Banking and Business Law Section, and the Antitrust Law Section of the American Bar Association."

The Executive Committee, at its Mid-year Meeting held February 17 and 18, 1968, in Chicago, Illinois, "voted to authorize the appointment of a Special Committee on Uniform Trade Secrets Protection Act to investigate the question of drafting an act on the subject with instructions to establish liaison with the Patent Law Section, the Corporation, Banking and Business Law Section, and the Antitrust Law Section of the American Bar Association." Pursuant to that action, a Special Committee was appointed, which included Professor Richard Cosway of Seattle, Washington, who is the only original Committee member to serve to the present day. The following year saw substantial changes in the membership of the Committee. Professor Richard F. Dole, Jr., of Iowa City, Iowa, became a member then and has served as a member ever since.

The work of the Committee went before the Conference first on Thursday afternoon, August 10, 1972, when it was one of three Acts considered on first reading. Thereafter, for a variety of reasons, the Committee became inactive, and, regrettably, its original Chairman died on December 7, 1974. In 1976, the Committee became active again and presented a Fifth Tentative Draft of its proposed bill at the 1978 Annual Meeting of the National Conference of Commissioners on Uniform State Laws.



Despite the fact that there had previously been a first reading, the Committee was of the opinion that, because of the lapse of time, the 1978 presentation should also be considered a first reading. The Conference concurred, and the bill

was proposed for final reading and adoption at the 1979 Annual Meeting.

On August 9, 1979, the Act was approved and recommended for enactment in all the states.

### Commissioners' Comment to Section 1 (A.C.A. § 4-75-601)

One of the broadly stated policies behind trade secret law is "the maintenance of standards of commercial ethics." *Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470 (1974). The Restatement of Torts, Section 757, Comment (f), notes: "A complete catalogue of improper means is not possible," but Section 1(1) (A.C.A. § 4-75-601(1)) includes a partial listing.

Proper means include:

1. Discovery by independent invention;
2. Discovery by "reverse engineering", that is, by starting with the known product and working backward to find the method by which it was developed. The acquisition of the known product must of course, also be by a fair and honest means, such as purchase of the item on the open market for reverse engineering to be lawful;

3. Discovery under a license from the owner of the trade secret;

4. Observation of the item in public use or on public display;

5. Obtaining the trade secret from published literature.

Improper means could include otherwise lawful conduct which is improper under the circumstances; e.g., an airplane overflight use as aerial reconnaissance to determine the competitor's plant layout during construction of the plant. *E. I. du Pont de Nemours & Co., Inc. v. Christopher*, 431 F.2d 1012 (CA 5, 1970), cert. den. 400 U.S. 1024 (1970). Because the trade secret can be destroyed through public knowledge, the unauthorized disclosure of a trade secret is also a misappropriation.

The type of accident or mistake that can result in a misappropriation under Section 1(2)(ii)(C) (A.C.A. § 4-75-601(2)(B)(iii)) involves conduct by a person seeking relief that does not constitute a failure of efforts that are reasonable under the circumstances to maintain its secrecy under Section 1(4)(ii) (A.C.A. § 4-75-601(4)(B)).

The definition of "trade secret" contains a reasonable departure from the Restatement of Torts (First) definition which required that a trade secret be "continuously used in one's business." The broader definition in the proposed Act extends protection to a plaintiff who has not yet had an opportunity or acquired the means to put a trade secret to use. The definition includes information that has commercial value from a negative viewpoint, for example the results of a lengthy and expensive research which proves that a certain process will not work could be of great value to a competitor.

Cf. *Telex Corp. v. IBM Corp.*, 510 F.2d 894 (CA 10, 1975) per curiam, cert. dismissed 423 U.S. 802 (1975) (liability imposed for developmental cost savings with respect to product not marketed). Because a trade secret need not be exclusive to confer a competitive advantage, different independent developers can acquire rights in the same trade secret.

The words "method, technique" are intended to include the concept of "know-how."

The language "not being generally known to and not being readily ascertainable by proper means by other persons" does not require that information be generally known to the public for trade secret rights to be lost. If the principal person who can obtain economic benefit from information is aware of it, there is no trade secret. A method of casting metal, for example, may be unknown to the general public but readily known within the foundry industry.

Information is readily ascertainable if it is available in trade journals, reference books, or published materials. Often, the nature of a product lends itself to being readily copied as soon as it is available on the market. On the other hand, if reverse engineering is lengthy and expensive, a person who discovers the trade secret through reverse engineering can have a

trade secret in the information obtained from reverse engineering.

Finally, reasonable efforts to maintain secrecy have been held to include advising employees of the existence of a trade secret, limiting access to a trade secret on "need to know basis", and controlling plant access. On the other hand, public disclosure of information through display, trade journal publications, advertising, or other carelessness can preclude protection.

The efforts required to maintain secrecy are those "reasonable under the circumstances." The courts do not require that extreme and unduly expensive procedures be taken to protect trade secrets against flagrant industrial espionage. See *E. I. du Pont de Nemours & Co., Inc. v. Christopher*, supra. It follows that reasonable use of a trade secret including controlled disclosure to employees and licensees is consistent with the requirement of relative secrecy.

### Commissioners' Comment to Section 2 (A.C.A. § 4-75-604)

Injunctions restraining future use and disclosure of misappropriated trade secrets frequently are sought. Although punitive perpetual injunctions have been granted, e.g., *Elcor Chemical Corp. v. Agri-Sul, Inc.*, 494 S.W.2d 204 (Tex.Civ.App.1973), Section 2(a) (A.C.A. § 4-75-604(a) and (b)) of this Act adopts the position of the trend of authority limiting the duration of injunctive relief to the extent of the temporal advantage over good faith competitors gained by a misappropriator. See, e.g., *K-2 Ski Co. v. Head Ski Co., Inc.*, 506 F.2d 471 (CA9, 1974) (maximum appropriate duration of both temporary and permanent injunctive relief is period of time it would have taken defendant to discover trade secrets lawfully through either independent development or reverse engineering of plaintiff's products).

The general principle of section 2(a) (A.C.A. § 4-75-604(a) and (b)) and (b) (A.C.A. § 4-75-604(c)) is that an injunction should last for as long as is necessary, but no longer than is necessary, to eliminate the commercial advantage or "lead time" with respect to good faith competitors that a person has obtained through misappropriation. Subject to any additional period of restraint necessary to negate lead time, an injunction accordingly should terminate when a former trade secret becomes either generally known to good faith competitors or generally knowable to them because of the lawful availability of products that can be reverse engineered to reveal a trade secret.

For example, assume that A has a valuable trade secret of which B and C, the other industry members, are originally unaware. If B subsequently misappropri-

ates the trade secret and is enjoined from use, but C later lawfully reverse engineers the trade secret, the injunction restraining B is subject to termination as soon as B's lead time has been dissipated. All of the persons who could derive economic value from use of the information are now aware of it, and there is no longer a trade secret under section 1(4) (A.C.A. § 4-75-601(4)). It would be anticompetitive to continue to restrain B after any lead time that B had derived from misappropriation had been removed.

If a misappropriator either has not taken advantage of lead time or good faith competitors already have caught up with a misappropriator at the time that a case is decided, future disclosure and use of a former trade secret by a misappropriator will not damage a trade secret owner and no injunctive restraint of future disclosure and use is appropriate. See, e.g., *Northern Petrochemical Co. v. Tomlinson*, 484 F.2d 1057 (CA7, 1973) (affirming trial court's denial of preliminary injunction in part because of an explosion at its plant prevented an alleged misappropriator from taking advantage of lead time); *Kubik, Inc. v. Hull*, 185 USPQ 391 (Mich.App.1974) (discoverability of trade secret by lawful reverse engineering made by injunctive relief punitive rather than compensatory).

Section 2(b) (A.C.A. § 4-75-604(c)) deals with a distinguishable situation in which future use by a misappropriator will damage a trade secret owner but an injunction against future use nevertheless is unreasonable under the particular circumstances of a case. Situations in which this unreasonableness can exist include the existence of an overriding public interest



which requires the denial of a prohibitory injunction against future damaging use and a person's reasonable reliance upon acquisition of a misappropriated trade secret in good faith and without reason to know of its prior misappropriation that would be prejudiced by a prohibitory injunction against future damaging use. *Republic Aviation Corp. v. Schenk*, 152 USPQ 830 (N.Y.Sup.Ct.1967) illustrates the public interest justification for withholding prohibitory injunctive relief. The court considered that enjoining a misappropriator from supplying the U.S. with an aircraft weapons control system would have endangered military personnel in Viet Nam. The prejudice to a good faith third party justification for withholding prohibitory injunctive relief can arise upon a trade secret owner's notification to a good faith third party that the third party has knowledge of a trade secret as a result of misappropriation by another. This notice suffices to make the third party a misappropriator thereafter under section 1(2)(ii)(B)(I) (A.C.A. § 4-75-601(2)(B)(ii)(a)). In weighing an aggrieved person's interests and the interests of a third party who has relied in good faith upon his or her ability to utilize information, a court may conclude that restraining future use of information by the third party is unwarranted. With respect to innocent acquirers of misappropriated trade secrets, section 2(b) (A.C.A. § 4-75-604(c)) is consistent with the principle of 4 Restatement Torts (First) § 758(b) (1939), but rejects the Restatement's literal conferral of absolute immunity upon all third parties who have paid value in good faith for a trade secret misappropriated by another. The position taken by the Uniform Act is supported by *Forest Laboratories,*

*Inc. v. Pillsbury Co.*, 452 F.2d 621 (CA7, 1971) in which a defendant's purchase of assets of a corporation to which a trade secret had been disclosed in confidence was not considered to confer immunity upon the defendant.

When section 2(b) (A.C.A. § 4-75-604(c)) applies, a court is given discretion to substitute an injunction conditioning future use upon payment of a reasonable royalty for an injunction prohibiting future use. Like all injunctive relief for misappropriation, a royalty order injunction is appropriate only if a misappropriator has obtained a competitive advantage through misappropriation and only for the duration of that competitive advantage. In some situations, typically those involving good faith acquirers of trade secrets misappropriated by others, a court may conclude that the same considerations that render a prohibitory injunction against future use inappropriate also render a royalty order injunction inappropriate. See, generally, *Prince Manufacturing, Inc. v. Automatic Partner, Inc.*, 198 USPQ 618 (N.J.Super.Ct.1976) (purchaser of misappropriator's assets from receiver after trade secret disclosed to public through sale of product not subject to liability for misappropriation).

Section 2(c) (A.C.A. § 4-75-604(d)) authorizes mandatory injunctions requiring that a misappropriator return the fruits of misappropriation to an aggrieved person, e.g., the return of stolen blueprints or the surrender of surreptitious photographs or recordings.

Where more than one person is entitled to trade secret protection with respect to the same information, only that one from whom misappropriation occurred is entitled to a remedy.

### Commissioners' Comment to Section 3 (A.C.A. § 4-75-606)

Like injunctive relief, a monetary recovery for trade secret misappropriation is appropriate only for the period in which information is entitled to protection as a trade secret, plus the additional period, if any, in which a misappropriator retains an advantage over good faith competitors because of misappropriation.

Actual damage to a complainant and unjust benefit to a misappropriator are caused by misappropriation during this

time alone. See *Commar Products Corp. v. Universal Slide Fastener Co.*, 172 F.2d 150 (CA2, 1949) (no remedy for period subsequent to disclosure of trade secret by issued patent); *Carboline Co. v. Jarboe*, 454 S.W.2d 540 (Mo.1970) (recoverable monetary relief limited to period that it would have taken misappropriator to discover trade secret without misappropriation). A claim for actual damages and net profits can be combined with a claim for

injunctive relief, but if both claims are granted the injunctive relief ordinarily will preclude a monetary award for a period in which the injunction is effective.

As long as there is no double counting, Section 3(a)\* (A.C.A. § 4-75-606) adopts the principle of the recent cases allowing recovery of both a complainant's actual losses and a misappropriator's unjust benefit that are caused by misappropriation. E.g., *Tri-Tron International v. Velto*, 525 F.2d 432 (CA9, 1975) (complainant's loss and misappropriator's benefit can be combined). Because certain cases may have sanctioned double counting in a combined award of losses and unjust benefit, e.g., *Telex Corp. v. IBM Corp.*, 510 F.2d 894 (CA10, 1975) (per curiam), cert. dismissed, 423 U.S. 802 (1975) (IBM recovered rentals lost due to displacement by misappropriator's products without deduction for expenses saved by displacement; as a result of rough approximations adopted by the trial judge, IBM also may have recovered developmental costs saved by misappropriator through misappropriation with respect to the same customers), the Act adopts an express prohibition upon the counting of the same item as both a loss to a complainant and an unjust benefit to a misappropriator.

Monetary relief can be appropriate whether or not injunctive relief is granted under section 2 (A.C.A. § 4-75-604). If a person charged with misappropriation has acquired knowledge of a trade secret

in good faith without reason to know of its misappropriations by another, however, the same considerations that can justify denial of all injunctive relief also can justify denial of all monetary relief. See *Conmar Products Corp. v. Universal Slide Fastener Co.*, 172 F.2d 1950 (CA2, 1949) (no relief against new employer of employee subject to contractual obligation not to disclose former employer's trade secrets where new employer innocently had committed \$40,000 to develop the trade secrets prior to notice of misappropriation).

If willful and malicious misappropriation is found to exist, section 3(b)\* authorizes the court to award a complainant exemplary damages in addition to the actual recovery under section 3(a)\* (A.C.A. § 4-75-606) an amount not exceeding twice that recovery. This provision follows federal patent law in leaving discretionary trebling to the judge even though there may be a jury, compare 35 U.S.C. § 284 (1976).

Whenever more than one person is entitled to trade secret protection with respect to the same information, only that one from whom misappropriation occurred is entitled to a remedy.

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\*The Arkansas version did not adopt former (b) of Section 3 but renumbered (a) as the new (a) and (b).

#### **Commissioners' Comment to Section 4 (A.C.A. § 4-75-607)**

Section 4 (A.C.A. § 4-75-607) allows a court to award reasonable attorney fees to a prevailing party in specified circumstances as a deterrent to specious claims of misappropriation, to specious efforts by a misappropriator to terminate injunctive relief, and to willful and malicious misappropriation. In the latter situation, the court should take into consideration the

extent to which a complainant will recover exemplary damages in determining whether additional attorney's fees should be awarded. Again, patent law is followed in allowing the judge to determine whether attorney's fees should be awarded even if there is a jury, compare 35 U.S.C. Section 285 (1976).

#### **Commissioners' Comment to Section 5 (A.C.A. § 4-75-605)**

If reasonable assurances of maintenance of secrecy could not be given, meritorious trade secret litigation would be chilled. In fashioning safeguards of confidentiality, a court must ensure that a respondent is provided sufficient informa-

tion to present a defense and a trier of fact sufficient information to resolve the merits. In addition to the illustrative techniques specified in the statute, courts have protected secrecy in these cases by restricting disclosures to a party's counsel



and his or her assistants and by appointing a disinterested expert as a special

master to hear secret information and report conclusions to the court.

#### **Commissioners' Comment to Section 6 (A.C.A. § 4-75-603)**

There presently is a conflict of authority as to whether trade secret misappropriation is a continuing wrong. Compare *Monolith Portland Midwest Co. v. Kaiser Aluminum & Chemical Corp.*, 407 F.2d 288 (CA9, 1969) (no continuing wrong under California law — limitation period upon all recovery begins upon initial misappropriation) with *Underwater Storage, Inc. v. U. S. Rubber Co.*, 371 F.2d 950 (CA9, 1966), cert. den., 386 U.S. 911 (1967) (continuing wrong under general principles — limitation period with re-

spect to a specific act of misappropriation begins at the time that the act of misappropriation occurs).

This Act rejects a continuing wrong approach to the statute of limitations but delays the commencement of the limitation period until an aggrieved person discovers or reasonably should have discovered the existence of misappropriation. If objectively reasonable notice of misappropriation exists, three years is sufficient time to vindicate one's legal rights.

#### **Commissioners' Comment to Section 7 (A.C.A. § 4-75-602)**

This Act is not a comprehensive remedy. It applies to duties imposed by law in order to protect competitively significant secret information. It does not apply to duties voluntarily assumed through an express or an implied in-fact contract. The enforceability of covenants not to disclose trade secrets and covenants not to com-

pete that are intended to protect trade secrets, for example, are governed by other law. The Act also does not apply to duties imposed by law that are not dependent upon the existence of competitively significant secret information, like an agent's duty of loyalty to his or her principal.







